Does Corporate Diversification Retrench the Effects of Firm-Level Political Risk?

M. Kabir Hassan[1], M. Sydul Karim[2], Tarun Mukherjee[1]

[1]Professor, Department of Economics and Finance, University of New Orleans, New Orleans

[2]PhD Student, Department of Economics and Finance, University of New Orleans, New Orleans

Introduction

Hassan et al. (2019) find that an overwhelming portion (i.e., 90%) of the variation in their measure of political risk occurs at the firm level rather than at the aggregate or sector level. As a result, firm-level political uncertainty (PU) brings about severe financial consequences for firms. The purpose of our paper is to examine the role that the organizational form might play in combating the firm-level risk endangered by PU. Specifically, we investigate if a diversified firm is better able to control the firm-level impact of PU than a focused firm. Additionally, we examine whether diversification intensity determines the extent to which the adverse effects of political risk are mitigated. In doing so, we employ the measures of PU risks developed by Hassan et al. (2019).

Results and Discussions

We begin our analysis with the following baseline regression models where we investigate the impact of political risk on firm-level investments and profitability through the interaction effects between political risk and diversification.

$$y_{i,t} = \beta_0 + \beta_1 \text{Prisk}_{i,t} + \beta_2 \text{Diversified}_{i,t} + \beta_3 \text{Prisk}_{i,t} \times \text{Diversified}_{i,t} + \gamma X_{it} + \delta_t + \delta_i + \delta_t \times \delta_i + \epsilon_{it}$$

We identify a firm as industrially diversified (dummy variable takes on the value of 1) when it has one or more business segments operate in more than one industry segment identified by 4-digit SIC codes. To determine the levels of industrial diversification, we group the diversified firms into moderate and high diversification categories (Shin and Stulz, 1998).

Table 1: Results from baseline regression

Variable	CAPX	Mark-Up	ROA
PRISK	-0.011***	-0.021***	-0.013***
DIVERSIFIED	-0.039***	-0.023***	-0.019***
DIVERSIFIED * PRISK	0.010**	0.018***	0.007**

We observe that both political risk and diversification effects are negatively associated with all three dependent variables at the 1% significance level. The Prisk coefficients indicate that if political risk increases by one standard deviation, firms observe a 1.1% reduction in the investments, a 2.1% decrease in Mark-up, and a 1.3% decrease in the ROA. The diversified coefficients suggest that diversified firms, on average, invest 3.9% less and have 2.3% less Mark-up and 1.9% less ROA than focused firms. The effect of diversification on investments is 3.28 times worse than political risk. The interaction term suggests that diversification mitigates the effects of political risk on investing and operating activities. For a given firm-level political risk, a diversified firm on average has 1.0% more investments, 1.8% more Mark-up, and 0.7% more ROA compared to the focused firms. Similar results hold for level of diversification.

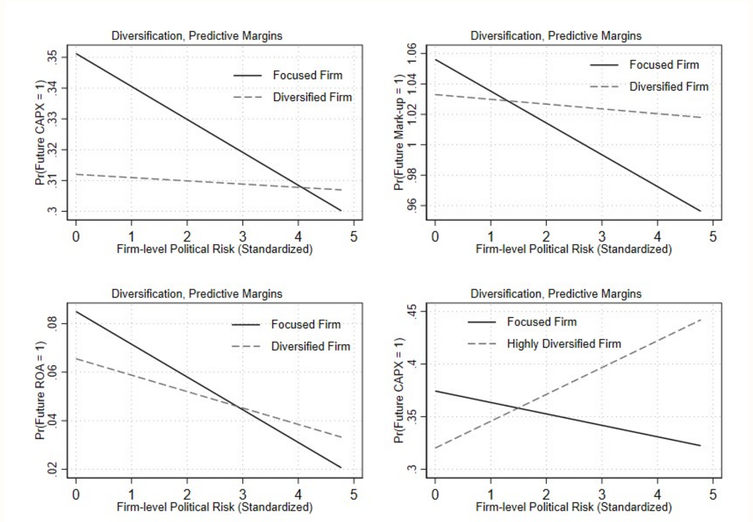

Figure 1: Marginal Effects of interaction between diversification and political risk

Falsification Tests

We conduct two falsification tests. First, we control for firm-level non-political risk and overall risk. Second, we examine the impacts of political risk on investments and operating performance of the diversified and focused firms at the time of high economic policy uncertainty (EPU). If the adverse impacts of PU on investments and profitability are mainly driven by the overall risks or economic policy uncertainty , then controlling for these measures should significantly weaken the estimated coefficient of PU. Our results indicate neither the overall risk nor EPU is as significantly associated with the outcome variables as PU does.

Active management of political risk

Next, we empirically investigate the mechanisms diversified firms imply to manage the adverse impacts of PU. In doing so, first, we check whether the internal capital markets of diversified firms allow them to outperform the focused firms in lessening the adverse effects of PU. Second, we check if the superior ability of diversification in mitigating political risk is derived from its more intensive involvements in political activities.

Table 2: Role of internal capital in managing political risk

Variable	Diver	ModDiver	HighDiver
SC	0.016**	0.012*	0.001
OSC	0.0080	0.005	0.027***
SPR	-0.008***	-0.009***	-0.0003
SPR*SC	0.048***	0.057***	0.039*
SPR*OSC	0.038***	0.047***	-0.003

Where the dependant variable is capx. The estimated coefficients of Segment PRISK(SPR) $\times$ Segment Cashflow(SC) and SPR $\times$ Other Segments Cashflow (OSC) suggest that when faced with an increased level of political risk, segments become more sensitive not only to their own-cashflow (SPR $\times$ SC) but also to the cash-flow of other segments (SPR $\times$ OSC). The sensitivity of a segment's investments to its cashflow in a high political risk environment (SPR $\times$ SC) is significantly larger than its sensitivity to other segments' cash-flow (SPR $\times$ OSC) except for the highly diversified firms. The estimated coefficient of different segments' cashflow (OSC) suggests that the internal capital market more actively supports operating activities for moderately diversified firms and investments for highly diversified firms in the ordinary course of business. Interestingly, the interaction of SPR $\times$ OSC shows that the internal capital market shifts its focus and pays keen attention to support investments when political risks are high: this agrees with the results of baseline regression that diversification retrenches the effect of firm-level political risk.

Managing political risk politically?

We test if the superior ability of a diversified firm to reduce the firm-level PU is possibly due to its ability to spend more on lobbying and PAC. A positive and significant interaction between the diversified firm and political risk for the subsequent period's political spending would weaken the contribution of the internal capital market in mitigating PU.

$$z_{i,t+1} = \beta_0 + \beta_1 \text{Prisk}_{i,t} + \beta_2 \text{Diversified}_{i,t} + \beta_3 \text{Prisk}_{i,t} \times \text{Diversified}_{i,t} + \gamma \Theta_{it} + \delta_t + \delta_i + \delta_t * \delta_i + \epsilon_{it}$$

Our dependent variable $Z_{i,t+1}$ represents PAC and lobbying variables. The primary variable of interest, the interaction term between diversification and political risk, indicates that diversified firms do not spend more money on lobbying and political donation than focused firms to reduce political risk.

Contribution

First, we show that the diversification strategy plays a vital role in mitigating adverse effects stemming from the firm-level political risk. Second, we show the power of diversification in managing the within-firm differences in the remaining 92 percent. Third, we show that it is the internal capital market that is instrumental in combating investment inefficiency stemming from PU. Fourth, we show that diversified and focused firms do not behave any differently in lobbying expenses and political donations in subsequent periods: this bolsters our argument that it is the internal capital market and not the political strategy that is the primary driver in political risk management. Finally, by addressing the cross-sectional variation in firm-level political risks, we document that diversification benefits exceed the costs stemming from the firm-level political uncertainty.

Summary and conclusions

This study investigates the effects of firm-level political risk on corporate investments and operating performance. We find that diversified firms are better able than focused firms in mitigating idiosyncratic political risk. Diversified firms accomplish this feat via efficient use of the internal capital market that allows segments to alleviate the adversity of political uncertainty. When exposed to political risk, diversified firms do not spend more on lobbying and political donations than the focused firms in the subsequent period, implying that diversified firms do not manage political risk politically. Our main findings are robust to a battery of endogeneity tests.

References

[1] Hassan, T.A., Hollander, S., van Lent, L., Tahoun, A., 2019. *The Quarterly Journal of Economics*

[2] Shin, H.H., Stulz, R.M., 1998 *The Quarterly Journal of Economics*