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

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Presenter: M Sydul Karim
AFA Ph.D. Student Poster Session-2021
Firm-level Political Risk

- Political decisions on regulation and govt. expenditure have a major impact on business environment.
- Outcomes of these decisions often hard to predict (Trump agenda, health care, immigration reforms).
- Effects of risk on behavior of firms might outweigh potential upside of well-meaning reforms.
- How do firms react to political risk is difficult to measure in the absence of a measurement of firm-level political risk.
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Evidence of Firm-level political Risk

- President Trump’s Twitter attacks on Amazon indicting the firm for exploiting U.S. Post Office, avoiding taxes, and using the Washington Post as a covert lobbying tactic.

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Objective of the Study

- 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 ask the following questions not addressed in the literature before:
  - Whether a diversified firm is better able to control the firm-level impact of PU than a focused firm?
  - If so, what are potential mechanisms through which diversified firms achieved this feat?
  - Does internal capital market help combating PU?
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We begin our analysis with the following baseline regression model:

**Baseline Model:** $y_{i,t} = \beta_0 + \beta_1 Prisk_{i,t} + \beta_2 Diversified_{i,t} + \beta_3 Prisk_{i,t} \times Diversified_{i,t} + \gamma X_{it} + \delta_t + \delta_i + \delta_t \times \delta_i + \epsilon_{it}$

- We identify a firm is industrially diversified when it has one or more business segments operate in more than one industry segment identified by 4-digit SIC codes.
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**Table: Panel A – Diversification and Political Risk**

<table>
<thead>
<tr>
<th>Variable</th>
<th>CAPX</th>
<th>Mark-Up</th>
<th>ROA</th>
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<tbody>
<tr>
<td>PRISK</td>
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**Table: Panel B – Moderate Diversification and Political Risk**

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Table: Panel C – High Diversification and Political Risk

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Figure: Marginal Effects of interaction between diversification and political risk
Falsification Tests

We conduct two falsification tests by controlling for:

- firm-level non-political risk and overall risk.
- the effects of 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.
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### Falsification Tests

<table>
<thead>
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<th>Mark-Up</th>
<th>ROA</th>
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<td>-0.003*</td>
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<tr>
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<td>0.017***</td>
<td>0.007***</td>
<td>0.001***</td>
<td>0.018***</td>
<td>0.007***</td>
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<tbody>
<tr>
<td>PRISK</td>
<td>-0.009***</td>
<td>-0.013***</td>
<td>-0.011***</td>
<td>-0.012***</td>
<td>-0.019***</td>
<td>-0.013***</td>
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<tr>
<td>LN(1+EPU)</td>
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<td>0.023***</td>
<td>0.007**</td>
<td>-0.005</td>
<td>0.032***</td>
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<td>DIVERSIFIED</td>
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<td>-0.013***</td>
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<td>DIVERSIFIED * PRISK</td>
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<td>0.018***</td>
<td>0.006***</td>
<td>0.008***</td>
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</table>
Role of internal capital in managing political risk

\[
\frac{y_{i,j}(t)}{TA_j(t - 1)} = a + b \frac{Sales_{i,j}(t) - Sales_{i,j}(t - 1)}{Sales_{i,j}(t - 1)} + c \frac{Cashflow_{i,j}(t)}{TA_j(t - 1)} \\
+ d \frac{Cashflow_j(t) - Cashflow_{i,j}(t)}{TA_j(t - 1)} + e q_{i,j}(t-1) + f Prisk_{i,j}(t - 1) \\
+ g \frac{Cashflow_{i,j}(t)}{TA_j(t - 1)} \times Prisk_{i,j}(t-1) + h \frac{Cashflow_j(t) - Cashflow_{i,j}(t)}{TA_j(t - 1)} \\
\times Prisk_{i,j}(t - 1) + \eta_{i,j} + \theta_j + \epsilon_{i,j}(t)
\]

where,

- \( Y_{i,j} \) = Gross capital expenditure (capxs) or Mark-up of the \( i^{th} \) segment of firm \( j \) during the year \( t \).
- \( Prisk_{i,j}(t - 1) \) = Political risk of \( i^{th} \) segment of firm \( j \) during the year \( t-1 \).
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<table>
<thead>
<tr>
<th>Variable</th>
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<tr>
<td>SC</td>
<td>0.016**</td>
<td>0.012*</td>
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<tr>
<td>OSC</td>
<td>0.0080</td>
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<td>SPR</td>
<td>-0.008***</td>
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<td>SPR*SC</td>
<td>0.048***</td>
<td>0.057***</td>
<td>0.039*</td>
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<tr>
<td>SPR*OSC</td>
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<td>0.047***</td>
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Where the dependant variable is capx.

The estimated coefficients of Segment PRISK(SPR) × Segment Cashflow(SC) and SPR × 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 × SC) but also to the cash-flow of other segments (SPR × OSC).
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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.

\[ z_{i,t+1} = \beta_0 + \beta_1 Prisk_{i,t} + \beta_2 Diversified_{i,t} + \beta_3 Prisk_{i,t} \times Diversified_{i,t} + \gamma \Theta_{it} + \delta_t + \delta_i + \delta_t \times \delta_i + \epsilon_{it} \]

- 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.
- Results indicate that diversified firms do not spend more money on lobbying and political donation than focused firms to reduce political risk.
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Political connection, lobbying, firm-level political risk, and diversification

<table>
<thead>
<tr>
<th>Div</th>
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<th>log(1+$Lobby),t+1</th>
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Contributions

- We show that the diversification strategy plays a vital role in mitigating adverse effects stemming from the firm-level political risk.
- We show that it is the internal capital market that is instrumental in combating investment inefficiency stemming from PU.
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- Diversified firms accomplish this feat via efficient use of the internal capital market that allows segments to alleviate the adversity of political uncertainty.
- Our main findings are robust to a battery of endogeneity tests.
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Thanks!