The Effect of Forced Refocusing on the Value of Diversified Business Groups[*]

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This paper studies how investors responded when Chinese regulators required large, publicly traded companies to divest their non-core hotel and real estate assets in 2010. This quasi-experiment allows direct estimates of the effect of diversification on value that are free from common selection problems. For firms with nontrivial divestitures, stock prices rose 2.3 to 3.5 percent on average, suggesting that diversification was value-destroying. The highest returns were for companies in which the ultimate controller had small cash flow rights, suggesting that investors were concerned about inefficient investment or tunneling. The "excess value/diversification discount" does not predict the announcement return.

March 2015

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1. Introduction

Diversified business groups, often with significant state control, are a core part of most emerging economies.[1] Given the strikingly different nature of business organization in emerging economies compared to the industrialized West, an important research question is how well our existing theories of corporate behavior – largely developed by studying independent companies with private owners in the United States and Western Europe – extend to this fast-growing segment of the world economy.

This purpose of this study is to assess the efficiency of diversification in business groups in the world's second largest economy, China, which is home to numerous state-controlled business groups that are dominant in several sectors of the economy. The analysis seeks to distinguish two broad views of the economic function of business groups. One view is that these groups have a competitive advantage because they are able to move resources internally at lower cost than across markets. Theoretically, this may take the form of winner-picking (Williamson, 1974; Stein, 1997; Matsusaka and

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[1] Countries in which business groups are common include Argentina, Brazil, Chile, China, India, Indonesia, Korea, Mexico, Pakistan, Philippines, Thailand, and Turkey. For surveys on business groups, see Khanna and Yafeh (2007) and Morck et al. (2005). Musacchio and Lazzarini (2012) document the prevalence of state-controlled enterprises.

Nanda, 2002) or coinsurance/propping (Khanna and Yafeh, 2005). Internal transfers may be particularly advantageous in emerging economies because external markets are underdeveloped. There is ample evidence that business groups do engage in such transfers, and the transfers appear to follow patterns consistent with efficient resource allocation.[2] The other view is that these groups are less efficient because controlling shareholders channel group resources to inefficient investments that provide private benefits, or divert corporate resources to related controlled business entities (tunneling). Theoretically, inefficient investment may be caused by internal politics (Scharfstein and Stein, 2000; Ozbas, 2005), managerial agency problems, and empire building, and tunneling may be invited by weak cash flow rights of corporate decision makers (Johnson et al., 2000; Morck and Yeung, 2003). There is also ample evidence that inefficient investment and tunneling takes place within groups.[3] What appears to be lacking in the literature – and what we attempt to supply – is evidence on whether efficient or inefficient internal allocations dominate on average, that is, whether on net diversified business groups add or destroy value.

Our research strategy exploits a quasi-experiment in China. Specifically, we examine how investors responded when Chinese regulators required publicly traded

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[2] Evidence includes Fisman and Wang (2010), He et al. (2013), Jia et al. (2013), and Peng et al. (2011) for China; Gopalan et al. (2007) for India; Chang and Hong (2000) and Bae et al. (2008) for Korea.
[3] Examples include Jiang et al. (2010) and Peng et al. (2011) for China; Cheung et al. (2006) for Hong Kong; Bertrand et al. (2002) for India; and Bae et al. (2002) for Korea.

companies in state-controlled business groups to divest their non-core hotel and real estate assets in 2010. Because all firms with non-core assets in these industries were forced to divest, this episode allows estimation of diversification's effect on value that does not suffer from the usual selection problems. We find that stock prices rose in response to the forced divestitures, meaning that investors viewed diversification as value-destroying on net in these business groups.

Existing research on the net effect of diversification on the value of business groups has faced significant challenges in causal inference due to selection issues. One common approach is to compare the performance of group and nongroup firms using accounting or market-based measures such as the excess value. The problem is that because firms choose to belong to a group, it is difficult to establish that the nongroup firms provide an appropriate counterfactual for the group firms. Another approach is to estimate the announcement return from a change in organization, such as a divestiture or refocusing program. In principle, the market's reaction to such an announcement provides an unbiased estimate of the value effect for firms that make an announcement. However, the set of firms that make an announcement is self-selected; to the extent that managers seek to increase firm value, the sample of firms making diversification announcements will be biased toward those that stand to benefit from the change.[4]

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[4] In the business group literature, Khanna and Palepu (2000) show that the average Tobin's Q is higher for members of diversified Indian business groups than nonmembers, and Claessens et al. (2002) find insignificantly lower Q's for group members compared to nonmembers across eight Asian economies.

In principle, an ideal experiment to estimate the net effect of diversification would involve having a random sample of firms exogenously shed their unrelated businesses. Implementing a field experiment along those lines is hard to imagine, but the unexpected issuance of two orders by China's State-owned Assets Supervision and Administration Commission (SASAC) in 2010 provides two quasi-experiments that share key features of the ideal experiment. SASAC's order required *all* central-government-controlled firms (CSOEs) that were not primarily in the hospitality or real estate businesses to divest their hotel and real estate assets. SASAC did not force refocusing on a random sample of firms, but as we discuss below, there is reason to believe that it chose these firms for macroeconomic reasons unrelated to the value consequences of diversification; to the extent this is true, the abnormal event return for targeted firms provides an estimate of the effect of refocusing on value without the selection problems that appear in similar studies. Our main finding is that companies forced to divest nontrivial assets experienced an abnormal return of 2.3 to 3.5 percent on average during the announcement period, suggesting that investors viewed diversification as a value-destroying strategy for these firms.

In order to conclude that the market's reaction is a response to a change in diversification, we attempt to rule out several alternative explanations for the market

Lins and Servaes (2002) find lower Q's and worse accounting performance for diversified than specialized firms in seven Asian economies, but do not distinguish group from nongroup firms. Bae et al. (2002) find that the price of firms in Korean business groups falls when they make an acquisition.

reaction. One possibility is that investors were responding not to refocusing but to news about the real estate sector that was conveyed in the divestiture orders. The rapid rise of land prices in China has led to fears of a real estate bubble, and the central government has become interested in managing this situation (Deng et al., forthcoming). If investors believed that a bubble was on the verge of popping, and interpreted the SASAC order as a signal that the government would intervene so as to prevent a massive price decline, the price of firms holding real estate assets would have increased following the announcement, consistent with what we find. We call this the "real estate bubble hypothesis." To rule out this explanation (and others based on peculiarities in the real estate market), we estimate the abnormal returns for local SOEs and private firms with hotel and real estate assets. We find that these firms did not experience a positive abnormal return comparable to that of the targeted firms, implying that the divestiture orders were not signaling general information about the real estate market.[5]

Another alternative explanation is that the divestiture orders signaled information about CSOEs in general, and the market was reacting to that information rather than refocusing. We assess this alternative by examining CSOEs that were not required to divest any assets (because they had no hotel or real estate operations). We

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[5] If investors interpreted the SASAC orders as a signal of *bad* news about the real estate industry, for example, that real estate prices were in fact a bubble that was soon to pop, this would have triggered an immediate *fall* in the value of real estate assets. Consequently, the companies forced to divest would have experienced a negative announcement return, contrary to what we find.

find that these other CSOEs did not experience a positive abnormal return in the announcement period, implying that investors were not interpreting the announcement as a signal of a general change in the regulation of CSOEs.

To shed additional light on whether the market was responding to the divestitures rather than some other information, we examine the relation between the abnormal return and the amount of assets that had to be divested; if the market response was not connected to the divestiture, then the abnormal return should have been independent of the amount of refocusing. We find that the abnormal return was higher for CSOEs that had to divest more assets, again suggesting that the market was reacting to the divestitures themselves.

After establishing that investors disliked diversification, the study explores why investors perceived diversification to be value destroying. Many factors have been identified as potential causes of inefficiency in internal markets. One prominent argument is that the incentive for inefficient investment and tunneling is greatest when the controlling shareholder has a small claim on the firm's cash flow (e.g. Claessens et al. 2002). Consistent with this argument, we find that abnormal returns are most positive for firms in which the controlling shareholder has limited cash flow rights, suggesting that the perception of value destruction in these firms stems in part from fear over the possibility of bad investment decisions. We do not find a reliable link between announcement returns and actual internal transactions in the form of

intercorporate related-party transactions (loans, loan guarantees, and asset and goods sales between controlled units) or by "other receivables," which includes intercorporate loans that have not been repaid. This suggests that related party transactions may include value-increasing as well as tunneling transactions, or that the bad investments that appears to concern investors do not take place through reported related party transactions. Our evidence does not rule out other sources of inefficiency, but suggests that weak cash flow rights may be one of the important factors.

Finally, although not our central purpose, we take advantage of the quasi-experiment to assess how well the "excess value" construct (also known as the "diversification discount") predicts the refocusing return for Chinese CSOEs. The excess value construct has been a mainstay of corporate diversification research since the publication of Lang and Stulz (1994), yet many studies have raised questions about whether it actually measures value destruction from diversification.[6] We compare each company's actual value change when forced to refocus with its estimated diversification discount using the excess value construct, and find a modest correlation of 0.13. This provides fairly direct evidence that the excess value is a weak proxy for the actual value

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[6] Matsusaka (2001) and Maksimovic and Phillips (2002) show theoretically how endogeneity of the diversification decision can lead to a diversification discount even if diversification is value maximizing. Empirical studies that provide evidence of a bias include Campa and Kedia (2002), Graham et al. (2002), Villalonga (2004a, 2004b); and Custodio (2014).

consequences of diversification in Chinese SOEs, and suggests caution in using the excess value to assess the consequences of diversification in business groups.

2. Institutional Background

A. *Importance of CSOEs*

The Chinese economy over the last several decades has been transformed from one in which all significant business enterprises were owned by the government to one in which state-owned and private enterprises coexist (Lardy, 2014). Although the private sector has been expanding, state-owned enterprises remain important in the aggregate and are dominant in some sectors. Figure 1 shows the percent of output attributable to SOEs and CSOEs. In 2011, SOEs accounted for 26.2 percent of output and CSOEs accounted for 15.1 percent of output. Deng et al. (forthcoming) report that SOEs accounted for 30.5 percent of nonfinancial assets in the country in 2008, and that listed SOEs comprised 27.9 percent of the total market capitalization of the Shanghai and Shenzhen stock market at the end of 2009.

The government's policy has been described as "grasping the big, letting go the small" (*zhua da fang xia*), meaning that its goal is to privatize most of the economy while retaining state control of the largest companies in strategically important sectors. In pursuit of this goal, the government has created a group of state-owned companies that have emerged as some of the largest businesses enterprises in the world. The 2014

Fortune Global 500 lists 95 Chinese firms among the 500 largest companies measured by revenue, of which 77 are SOEs. Three of the 10 largest companies in the world are now Chinese SOEs: Sinopec at #3, China National Petroleum at #4, and State Grid at #7. The rise of these enterprises has been rapid: in 2000 there were only 10 Chinese firms in the Global 500, eight of them state-owned. Although the company names connote well-defined industries, they are typically diversified. Table 1 reports the industrial diversification of 10 of the largest Chinese SOEs. All of this descriptive information suggests that to understand the Chinese economy – and perhaps the global economy – it is necessary to understand the economic logic of state-owned enterprises.

A. Organization of Chinese Business Groups and Relationship to the State

Our study examines how prices changed when large publicly traded firms were required to divest certain unrelated lines of business. The refocusing order came from the State-owned Assets Supervision and Administration Commission of the State Council (SASAC).[7] In order to interpret the evidence, it is useful to understand the organization of Chinese business groups and their relation to SASAC.

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[7] Much of the following material is drawn from Lin and Milhaupt (2013), Lin (2013), and Deng et al. (forthcoming), which contain a wealth of detailed contextual information about Chinese state-owned enterprises. In addition to the central SASAC, there are also provincial and local assets supervision and administration commissions.

SASAC was established in 2003 to act as the holding company for all enterprises owned by the central government (CSOEs). Before 2003, the CSOEs were parts of individual ministries; the reform separated the CSOEs from their ministries by "corporatizing" them – converting them to joint stock companies with ownership rights and governance structures regulated by law – and consolidating all ownership in SASAC. By changing the legal status of SOEs into companies formally distinct from the government, although still controlled through the commissions, the reform severed much of the bureaucratic control over SOE operations and gave SOE managers more autonomy over day-to-day business decisions while still allowing the government to exert influence at a broad policy level.

Originally, SASAC held 196 companies, but through consolidations the number of companies has fallen to 117 as of the middle of 2014. The parent (sometimes "core") company in each group is 100 percent owned by SASAC. The parent companies sit at the apex of extensive pyramid-structured business groups. In 2008, the groups controlled a total of 19,250 subsidiaries (Deng et al., forthcoming). Subsidiary companies in the group may not be fully owned and some are classified as non-SOEs. Most groups have a large subsidiary with publicly traded stock that serves as the company's external face; the parent company holds a controlling interest in these companies but there are also outside investors who have cash flow and governance

rights. Our empirical analysis focuses on these publicly traded CSOEs, and in particular, on the reaction of their outside investors.

B. Refocusing Events

Our analysis examines two announcements by SASAC that required CSOEs to restructure their hotel and real estate operations. On January 25, 2010, SASAC ordered every CSOE that was not primarily based in the tourism or hospitality business to exit the hotel industry (and also divest their restaurants) within three to five years. On March 18, 2010, a similar directive was issued calling for companies to shed their real estate assets if their primary business was not real estate.[8] The purpose of the SASAC orders was not stated publicly, but a prevailing view is that the orders were motivated by macroeconomic considerations, specifically, to cool off the country's booming real estate market (Deng et al., forthcoming).[9] Deng et al. (forthcoming) show that real estate prices rose 97 percent in 2009 in eight major cities, and the run-ups were partially driven by bidding from CSOEs; they also discuss at length the efforts by the central government to stimulate more investment by CSOEs following the financial crisis.[10]

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[8] We cannot study implementation yet because it is ongoing at the time of writing.
[9] A contemporaneous example from the business press is a story in *China Daily* that began: "In a move to curb soaring property prices, the state-assets watchdog on Thursday told major state-owned enterprises whose core business is not real estate to quit the market." (Hu, 2010).
[10] Deng et al. (forthcoming) discuss this episode in the context of the central government's attempt to stimulate the economy after the financial crisis. They argue that CSOEs entered the real estate market in 2009 in part as a way to implement a government mandate to increase investment (they argue that real estate offered short run benefits for managers that made it the most attractive investment opportunity at

Some media outlets speculated that the hotel divestitures were aimed at improving the performance of underperforming hotels, but others suspected that the government agencies might have had undisclosed interests in the divestment.[11]

One concern when conducting event studies is the possibility that the announcement was anticipated by investors. In China important regulatory changes are typically announced without prior discussion among outside groups so the announcement is the first real information to reach the market (Calomiris et al., 2010). This contrasts with the United States where policy announcements are preceded by public debate and lobbying. In the case of our two events, media coverage indicates that both came as surprises to investors, and market participants were puzzled about the reason for the policies.

For more formal evidence on whether the announcements were anticipated, we estimated the cumulative abnormal return over the five weeks preceding each announcement. The mean was -0.04 percent for the hotel and 0.03 percent for the real estate announcement.

Another concern when conducting event studies is the possibility that the announcement reveals or signals other information than the change in diversification

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the time). We are unable to determine how much of the to-be-divested assets were acquired in 2009 in response to the government stimulus program.

[11] For example, a story in *CaixinOnline* reported, "Sources close to SASAC said the move is aimed at reorganizing and integrating state-owned hotels, transferring them to companies that can manage them more efficiently. . . . Some industry experts were puzzled by the order, and wonder whether government agencies have unannounced interests in the divestments." (Wang et al., 2010).

itself. For example, in an event study that examines the return from diversifying acquisitions, the acquisition announcement may be driven by information about the means of payment or reflect a market inference that the acquirer has fewer internal investment opportunities than previously believed (Matsusaka, 2001). In our case, because all firms were ordered to divest, the announcement plainly does not carry any firm-specific information. One might speculate that the announcement changed expectations about the government's intentions going forward, but none of the media reports we reviewed interpreted the announcements as signals of a broad change in regulatory intensity. Below we also explore the return to government-owned firms that were not affected by the announcement; and find that their stock prices did not move in the same way as the firms that were forced to refocus.

A third concern with event studies is credibility of the announcement. Enforcement and implementation is not automatic in China, so investors might have been skeptical about whether the orders would be implemented (Calomiris et al., 2010). As it turns out, although the pace of divestiture has been slow, the targeted companies have been selling off their assets in the four years since the initial announcements so the orders appear to have been credible.[12] If investors entirely doubted that the orders

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[12] For hotels, see "SOEs check out of hotel business under SASAC rule," in China.org.cn (October 19, 2013). For real estate, see "More SOEs exit real estate market," in CaixinOnline (February 23, 2011) (Xu, 2011). To check credibility, we estimated abnormal returns on April 13, 2010 when several influential financial media outlets reported that some firms were continuing to acquire land despite having submitted divestiture plans, suggesting that implementation might be slower than originally believed.

would be followed, then the abnormal return would be zero, so this concern biases the effects toward zero.[13] Furthermore, we find (in unreported estimates) that firms subject to a divestiture order experienced more of an improvement in operating performance in the surrounding years than firms not subject to the order.

C. Objectives of CSOEs

When interpreting the evidence, a natural question is: what is objective function of managers of CSOEs? This question is the subject of ongoing research activity and does not yet have a convincing answer. It is clear that CSOEs are not simply arms of the government. The SASAC structure was established specifically to extract the government bureaucracy from day-to-day operational decisions of the companies. In terms of diversification, SASAC is empowered to define the primary business activity of each CSOE; CSOE managers thus need SASAC approval to change their primary business but otherwise do not require SASAC approval to acquire businesses in other industries (Deng et al., forthcoming). SASAC influence is also limited because while SASAC reports into the government hierarchy as a ministry-level agency, so do 53 of the most important SOEs under its supervision (Lin and Milhaupt, 2013).

The announcement returns were in the opposite direction from those associated with the original announcement, suggesting that the initial announcement was deemed credible at the time

[13] In unreported estimates, we found that the market's response was smaller for companies in which the CEO was politically connected (formerly having held a political office at the city or provincial level). One interpretation is that politically connected managers are better able to resist the forced refocusing, and therefore the market was less confident that the value destroying diversification would end.

The firms we study also differ from fully owned enterprises because their stock is publicly traded and they have outside investors as (minority) owners with cash flow and governance rights under Chinese law.[14] Each of these firms has a board of directors elected by shareholders, and the board has the right to hire and fire the managers. Shareholders also have the right to request or convene general meetings of shareholders, the right to make proposals, and the right to revoke decisions of the board, among other things. Of course, SASAC ultimately holds the most shares, so these rights do not wall off the government from corporate decisions, but the existence of these rights is likely to have some behavioral effects.

SASAC's stated mission is to preserve and increase the value of state assets while transforming SOEs into public companies. One way SASAC influences top manager incentives is through compensation, which it sets.[15] Top managers are paid a base salary and a bonus, with the base salary constituting about one-third of the total. Total compensation is not large by Western standards – the average compensation of a CEO at a CSOE in 2009 was about 600,000 RMB and the highest paid CEO in 2007 earned 1.3 million RMB – but the numbers are considerably higher than that received by top ministry-level civil servants. The bonus component is assigned based on a formal

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[14] Chinese corporate law has changed often and significantly over the last two decades. For an overview of Chinese company law at about the time of the announcement, see Gu (2010) and OECD (2011). On the government's role in corporate decision making, see SASAC's *Interim Measures for the Supervision and Administration of State-Owned Assets of the Enterprises*, issued in 2003.

[15] Our discussion of executive compensation and incentives relies on Lin (2013) and Deng et al. (forthcoming).

performance evaluation, part of which is a determined by quantitative metrics of performance: absolute profits, economic value added, appreciation in asset valuations, and annualized revenue growth in the primary line of business (plus share price appreciation in publicly traded units). Top managers are partially incentivized to pursue profit through the compensation system.

The primary influence on incentives is not through compensation, but the manager's career trajectory. CEOs do not remain in place for the rest of their careers, but rotate to other companies, government agencies, or political organs. After running a CSOE for a few years, the manager may be promoted to a higher position, moved laterally, or demoted. A manager's career path depends on his formal performance evaluations and a recommendation from SASAC, but the actual decision is made by the Organization Department of the Chinese Communist Party. Cao et al. (2014) show that a CEO is more likely to receive a promotion to a higher ranking political position if his or her company performs well; and Kato and Long (2006) show that a CEO is more likely to be removed if his or her firm performs poorly. At the same time, managers are expected to cooperative with the Party's broad policy goals: Deng et al. (forthcoming) show that career incentives are strong enough to allow the central government to direct broad movements in macroeconomic aggregates such as investment and lending.

In short, managers of state-owned enterprises have monetary and career incentives to maximize profit, as well as incentives to advance broader goals of the

Party. Of course, the incentive systems are likely to imperfect as in most corporations,
so managers may also have incentives to consume private benefits or misuse corporate
resources. One purpose of our study is to assess the net effect of these sometimes
contradictory incentives on managers' decision to pursue profit versus private benefits.

3. Methods and Data

To calculate abnormal announcement returns, for each firm we estimated the
parameters of a Fama-French three-factor model over a window running from 150 to 30
trading days before the announcement.[16] We then calculated the abnormal return for
each day, and summed them over an event window to arrive at the cumulative
abnormal return (CAR) associated with the announcement.[17] Daily stock price
information was taken from the GTA Database, part of which is available through
Wharton Research Data Services. Daily Fama-French factors were provided by RESSET,
a Chinese financial data vendor, headquartered in Beijing.[18] CARs are winsorized at the
1st and 99th percentiles. We present evidence for various windows, but most of our
analysis focuses on the conventional [-1, 1] window and a longer (-1,6] window that

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[16] For China, the Fama-French three-factor model is examined by Wang and Xu (2005). We also use a simple market model (MacKinlay 1997) to calculate the abnormal event returns and obtain near-identical results.

[17] For the hotel event, we use January 26, 2010 as day 0 because the announcement appears to have been made late in the afternoon of January 25 and was not discussed in the media until January 26. For the real estate event, we use March 18, 2010 as day 0.

[18] Corporate debt is rare in China, so we can focus on stock price movement as a measure of firm value.

allows for the possibility of slow information diffusion due to the immaturity of the Chinese stock market. We also estimate but do not report our findings for windows of [-1,2], [-1,3], [-1,4], and [-1,5], which produce similar results. We obtained conventional firm-level financial information (assets, capital expenditure, return on assets, cash flow, market-to-book) and ownership and cash flow rights data from the GTA Database.

To capture the intensity of internal capital markets, we obtained related party transaction (RPT) data from GTA's Related Party Transaction Database. We classify related party transactions into two types: (i) intercorporate loans and loan guarantees and (ii) intercorporate goods and service transactions.[19] Since we are interested in the overall activity level of the internal market, we sum the transactions of each type; that is, if the parent firm sells $100 of goods to a subsidiary, and the subsidiary sells $100 of goods to the parent firm, the total trading volume is $200. As another potential measure of tunneling, following Jiang et al. (2010), we also collected accounting information on "other receivables" for each listed company from this database, specifically, the value of loans outstanding at the end of each year provided by the listed firm to its controller.

Segment data from 2009 were hand-collected from annual reports. Some of the segments we study are organized as independent companies and others as divisions. China's Ministry of Finance, which sets accounting rules in China, requires all firms to

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[19] An inter-corporate loan guarantee differs from an inter-corporate loan in that the former is a contingent liability for the focal firm, that is, it is only a liability for the guarantor when the guaranteed defaults on the loan.

provide segment sales information in their annual reports. The rules require a firm to

break out segment information if (i) a segment's sales constitute more than 10 percent of

the company's total sales; (ii) a segment's absolute profit constitutes more than 10

percent of the firm's total profit; or (iii) a segment's assets constitute more than 10

percent of the total assets of the firm.[20] We collected segment sales information for all

publicly traded CSOEs, a total of 234 after dropping financial firms.[21] In our sample, 41

percent of firms have two segments, 23 percent have three segments, 17 percent have

four segments, 10 percent have five segments, 6 percent have six segments, and 1

percent have seven segments (this is similar to the distribution in Lang and Stulz (1994)

for American firms.)

We calculate the excess value for each listed firm following the method in Berger

and Ofek (1995). Excess value is defined as the ratio of a diversified firm's market value

to its imputed market value, minus one. The imputed market value of a segment is the

median market-to-sales multiple of single-segment firms in the industry. A diversified

firm's imputed value is the sales-weighted imputed value of its segments. Excess values

are winsorized at the 1st and 99th percentiles, and three observations with values above

1.0 are restated as 1.0. We work with excess values directly rather than logarithms

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[20] Most firms provide segment sales information even if a segment does not exceed the 10 percent threshold: 85 percent of sample firms report sales information for segments that produce less than 10 percent of total sale, and the smallest segment accounts for 0.14 percent of total sales of the listed firm.
[21] Because segments are often organized as independent subsidiaries of the listed firm, related party transaction regulations require the listed firm to provide financial information on the subsidiary. We use this information to verify the accuracy of the segment information collected from annual reports.

because a logarithmic transformation is a good approximation only in the vicinity of 1.0, and many observations are not close to 1.0. Results are similar with log values.

Table 2 reports summary statistics. The table distinguishes firms that were forced to divest hotel assets, firms that were forced to divest real estate assets, and CSOEs that were not forced to divest hotel or real estate assets.

4. Effect on Value

A. Response to Forced Refocusing Announcements

Table 3 reports cumulative abnormal returns (CARs) associated with the forced divestiture announcements. The first row (1) reports CARs for all 50 firms that were ordered to divest, that is, combining the 23 firms that were required to divest hotel assets and the 27 firms that were required to divest real estate assets. The mean CAR over the [-1, 1] event window was 1.0 percent, a number that is significantly different from zero at the 5 percent level. The CAR is larger for longer windows, growing to 2.0 percent over the [-1, 6] event window, a number that is different from zero at the 1 percent level of significance. The median abnormal return was 0.5 percent over the [-1, 1] window, and rises to 2.2 percent in the [-1, 6] window, both numbers different from zero at the 5 percent level. These numbers are consistent with the view that investors expected the companies to be worth more refocused than with their existing diversified lines of business.

Firms that were forced to divest but whose hotel or real estate holdings were miniscule are likely to have experienced little or no market reaction to the announcement. To provide cleaner estimates of the effect of refocusing, row (2) of Table 3 reports CARs for companies whose hotel or real estate holdings generated more than 2 percent of sales.[22] The CAR in this subsample had a mean of 2.3 percent over the [-1, 1] window, rising to 3.5 percent over the [-1, 6] window; the median was 1.8 percent over the [-1, 1] window, rising to 3.1 percent over the [-1, 6] window. All of these numbers are different from zero at the 1 percent level.

For companies required to divest a nontrivial quantity of assets, the mean abnormal return was in the range of 2.3 to 3.5 percent. One way to interpret the magnitude of this effect is to compare it with the value of the assets to be divested. By this metric, the median abnormal return is 38 percent of the sales generated by the assets to be divested over the [1, 1] window and 39 percent over the [-1, 6] window.

Rows (3) and (4) of Table 3 report the CARs separately for companies required to divest hotel and real estate assets. The mean and median CARs are positive in all cases. The market's response to forced refocusing was more positive in the hotel than real estate industries, but qualitatively similar, and CARs from the two events cannot be distinguished from each other statistically.

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[22] The 2 percent cutoff eliminates the tiniest divestitures while losing only about half of the sample. The findings are similar with cutoffs of 3, 4, and 5 percent.

B. Alternative Explanations

These findings are consistent with the hypothesis that investors believed that diversification into hotels and real estate destroyed value, and upgraded their expectation of future cash flows when they learned such diversification would come to an end. Here we consider alternative explanations for the findings that have nothing to do with diversification.

One possible explanation for the findings is that the announcements carried information about the real estate and hotel markets. According to what we call the real estate bubble hypothesis, the SASAC announcements sent a positive signal about the government's intention to manage the real estate market and prevent a price meltdown.[23] While not implausible, media stories at the time suggested that the government was concerned about real estate price growth and was trying to cool off the market, which would have depressed the price of companies holding real estate assets. To account for the positive abnormal return, the story would have to be along the lines that investors feared a major price correction, and SASAC's intervention led them to believe that the price adjustment would be more modest.

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[23] Other bubble-related hypotheses can be imagined if some investors are assumed to be irrational. For example, forced refocusing might increase value by forcing companies to divest overvalued the assets before prices crashed. To account for a positive announcement return, in effect this hypothesis requires that stock investors expected the buyers of the divested assets to overpay for them, or put differently, that investors were rational while the purchasers of divested assets were irrational.

To assess this alternative explanation more formally, we examine the announcement return for companies holding hotel and real estate assets that were not forced to refocus; these were SOEs controlled by local governments and private companies. The real estate bubble hypothesis would predict a positive abnormal return for these firms as well. Row (1) of Table 4 reports the abnormal return for local SOEs whose main business was either real estate (N = 58) or hotels (N = 6). The mean CAR during the [-1, 1] window was 0.8 percent, significant at the 5 percent level, and the mean return during the [-1, 6] window was -0.2 percent. These price movements are smaller than those for CSOEs. Row (2) of Table 4 reports analogous statistics for private companies whose main business was either real estate (N=73) or hotels (N=8). The mean CAR during the [-1, 1] window was 0.7 percent, and during the [-1, 6] window it was -0.9 percent; the first is number different from zero at the 10 percent level. This is inconsistent with the real estate bubble hypothesis. The hypothesis that the refocusing announcement was in some way a positive signal for the hotel or real estate industries is also undermined by the fact that the local SOE and private companies used for comparison had larger stakes in the real estate and hotel industries than the CSOEs; if the SASAC announcement signaled good news, we would expect a larger reaction from the non-CSOEs than the CSOEs. Also, it is likely that the local SOE and private company returns had a positive component from investors expecting them to be able to acquire hotel and real estate assets of the CSOEs at fire sale prices. Thus, it seems

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unlikely that the positive CARs for targeted companies were only due to developments in the real estate market and not to refocusing itself.[24]

Another possible explanation is that the announcements carried information about CSOEs more broadly, and the market was responding to this general CSOE information rather than the divestitures themselves. For example, the announcements could have signaled heightened government scrutiny of CSOEs – perhaps a crackdown on corruption or an increased emphasis on profits – or perhaps a relaxation of pre-existing pressure on CSOEs to invest as part of government stimulus plan (the historical review by Deng et al. (forthcoming) lends this possibility some plausibility). The media stories that we reviewed did not mention these possibilities.

To provide a statistical assessment, row (3) of Table 4 reports the CARs for CSOEs that were *not* required to divest hotel or real estate assets (meaning they did not hold hotel or real estate assets). If the announcements carried information about CSOEs in general, then we should see similar investor reactions for these CSOEs that did not have to refocus. In contrast, the CARs for the nonimpacted CSOEs are close to zero: over the [-1, 1] window, the mean CAR was 0.3 percent and the median was 0.2 percent;

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[24] Another real-estate-related hypothesis is that real estate assets were particularly toxic in some way that generated negative synergies, and therefore, forcing those assets to be divested increased value. This is essentially a specific version of the hypothesis that diversification destroys value. Our cross-sectional evidence below suggests that the source of value destruction lies elsewhere, but because our study is confined to refocusing involving hotel and real estate assets, we cannot conclude that the results would be the same for forced divestitures of other assets. This is a version of the external validity question that arises in all natural experiments.

only the median is different from zero at conventional levels of significance. Over the [-1, 6] window, the mean CAR was 0.0 percent and the median was -0.7 percent; neither value is different from zero at conventional levels of significance. Overall, we find little evidence that the market interpreted the forced refocusing announcements as auguring something positive for CSOEs in general.

The conjecture that the CARs were driven by something other than refocusing is also undercut by evidence that the reaction was larger for firms with larger divestitures. Table 5 reports regressions that further exploit the size of the divestiture by allowing the market response to vary with size of the divestiture, which can be thought of as the degree of exposure to the event. In these regressions, we include all CSOES, both those that were forced to refocus and those that were not, thus controlling for general CSOE returns. The regressions also permit inclusion of controls for other factors that might influence the return. We consider four firm characteristics: assets, market-to-book, earnings, cash, and investment.[25] Inclusion of these variables has advantages and disadvantages. By controlling for other factors that might determine the announcement return, they potentially allow more precise estimates of the refocusing effect. On the other hand, some of the control variables are known to be correlated with diversification – for example, diversified firms hold less cash (Duchin, 2010) – so the

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[25] We also explored, for all regressions reported in the paper, inclusion of a variable equal to the fraction of the firm owned by the government. Because this variable was statistically insignificant in all regressions and had no effect on the coefficients of interest, we did not include it in the final regressions.

control variables may end up capturing and stripping out some of the refocusing effect. Whether the benefit outweighs the cost of including these controls is unclear, but we present the regressions to flesh out the picture. The regressions also include a dummy variable for the real estate event and 2-digit industry-specific fixed effects.

Each column in Table 5 reports estimates from a regression in which the dependent variable is the CAR (as a percentage) over the event window indicated at the top of each column. The main explanatory variable throughout is the percentage of sales accounted for by the assets to be divested (%Divested). The regressions in columns (1) and (2), which depict the unconditional connection between the CARs and the size of the forced divestiture, show a positive relation – the size of the refocusing effect increases in the degree of exposure to the treatment. Both coefficients are different from zero at the 1 percent level of significance.

Columns (3) and (4) in Table 5 report regressions that include the control variables. The coefficient of interest on divestiture size remains positive and statistically significant in magnitude and the significance level declines. Again, given the existence of a correlation between diversification and the control variables, the controls probably are absorbing some of the refocusing effect.

Another limitation is that these regressions force the refocusing effect to be the same across the two events, which seems unlikely in light of the evidence in Tables 2 and 3. To address this concern, columns (5) and (6) of Table 5 report regressions in

which the effect of refocusing is allowed to vary across the two events by including an interaction term between the real estate event dummy and the forced divestiture size. The coefficient on the interaction term is negative and statistically different from zero, indicating that real estate divestitures were viewed less positively than hotel divestitures, and therefore that pooling the two events comes at a cost. The coefficient on divestiture size, which represents the market's response to the hotel divestitures, is positive and statistically significant in both regressions. The implied effect of refocusing for real estate divestitures is also positive, but smaller: 0.05 in regression (5) ($p = .134$) and 0.12 in regression (6) ($p = .051$).

Another potential concern is that the parameters on the control variables are not the same for the two events. To allow for this possibility, the last four columns of Table 5 report separate regressions for the hotel and real estate events. The coefficients on divestiture size are positive and statistically distinguishable from zero in all four regressions. The market's positive reaction to forced refocusing is a characteristic of both the hotel and real estate event.

Two additional points deserve mention here. First, although we report evidence using only two event windows, [-1, 1] and [-1, 6], the results are similar with other windows. Second, by including CSOEs that have no real estate or hotel assets to divest as the benchmark, we better control for CSOE-specific effects; in unreported results, we

limit the sample to the affected firms (that is, those with nonzero divestitures), and find

qualitatively similar results.

5. Explaining Variation in Announcement Returns

The evidence described in Tables 3-5 points to the conclusion that forced refocusing

created value for the impacted firms, meaning that investors believed diversification

was destroying value in these firms. We next investigate the extent to which existing

theory can explain why investors approved of the forced divestitures. The theory of the

firm following Grossman and Hart (1986) suggests that a core difference between a

diversified company and a set of stand-alone firms is that the controlling manager of

the diversified company has control rights that would otherwise be dispersed among

the individual firms. On the positive side, giving control rights to headquarters can

increase value by allowing winner-picking (Williamson, 1975; Stein, 1997; Matsusaka

and Nanda, 2002) or risk pooling (Gopalan et al. 2007; Khanna and Yafeh, 2005; Jia et al.,

2013). On the negative side, which seems more relevant given the evidence reported

above, giving headquarters control rights may lead to inefficient investments and in

extreme cases, tunneling of resources from the company's businesses to entities

affiliated with the controlling shareholder (Johnson et al., 2000; Morck and Yeung,

2003). Inefficient investments can take the form of socialistic cross-subsidization within

the group (Scharfstein and Stein, 2000; Ozbas, 2005) or diversion of resources into

private benefits such as favors to connected individuals that advance the manager's political career.

A. Controller's Cash Flow Rights

We begin with a variable that is commonly used in the literature to capture the controller's incentive to make inefficient investments and tunnel: the fraction of cash flow rights held by the company that ultimately controls the company (Claessens et al., 2002; Lemmon and Lins, 2003; Jiang et al., 2010). This variable, which ranges from .06 to .71, represents the wedge between control and cash flow rights.[26] As cash flow rights decline, the controller's incentive to invest inefficiently or to capture resources through intercorporate transfers dividends rises. If investors are concerned about inefficient investment, the forced refocusing return should be decreasing in the controller's cash flow rights.

Table 6 reports regressions that allow the announcement return to vary with the controller's ownership share. Each column in each panel reports estimates from a regression in which the dependent variable is the CAR over various windows. The regressions in panel A do not include the battery of control variables because of the

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[26] Other studies have considered the ratio of cash flow to control rights, for example Claessens et al. (2002). In the firms we study, the parent company owns the majority of stock in all cases, so the parent essentially has complete control, and all variation in the wedge between cash flow and control rights stems from variation in cash flow rights (that is, our approach is the same as existing literature with the specific feature that control rights are 100% in these CSOEs.)

concerns expressed above that they might be absorbing refocusing effects, while the panel B regressions include (but do not report) the control variables; as it turns out, the findings are similar with or without the control variables. All regressions include the percentage of sales that the target is forced to divest, and the sample consists of all CSOEs. Regressions (1), (2), (7), and (8) introduce the controller's cash flow rights, defined as the fraction of the firm's cash flow that is legally owned by the ultimate parent. The key variable is the interaction between the size of the divestiture and the controller's cash flow rights. In all four regressions, the coefficient is negative and statistically distinguishable from zero at the 5 percent level or better. Investors were more enthusiastic about forced refocusing when the controller's cash flow rights were small, suggesting that the positive CARs may be connected to fears of inefficient investment and tunneling. To interpret the magnitudes, the coefficients in regression (1) imply that a 10 percent divestiture produces a 1.5 $(= 1.00 \times (.36 - .71) - 0.53 \times (.36 - .71) \times 10)$ percent higher return if the controller's cash flow rights are 0.36 (the median) than if cash flow rights are 0.71 (the maximum).

B. Other Receivables

The coefficients on the controller's cash flow rights suggest that investors disliked diversified groups in which there was an incentive for inefficient investment and tunneling. In regressions (3), (4), (9), and (10) of Table 6 we investigate whether the

market's reaction can be traced specifically to tunneling by considering "other receivables" on the firm's balance sheet. Jiang et al. (2010) observe that in Chinese firms, "other receivables" often consist of intercorporate loans that have not been repaid, and argue that this is an indicator of tunneling from the unit. They show that firms with high levels of "other receivables" exhibited worse operating performance and were more likely to become distressed during the period 1996-2006. We follow Jiang et al. (2010) and construct the variable OREC by dividing other receivables with respect to the controller by total assets. Note that OREC is a characteristic of the firm that is forced to refocus, not the company/division to be divested. Thus, a high level of OREC, under the tunneling interpretation, should be seen as an indicator of tunneling in the group, not as a measure of tunneling that is occurring in the business to be divested.

As can be seen, the OREC coefficient is never distinguishable from zero at conventional levels of statistical significance, nor does it have a consistent sign. This could mean that inefficient investment is more of a concern than tunneling, or that OREC does not capture tunneling in the firms we study.[27]

The remaining columns in Table 6 include both the controller's cash flow rights and OREC at the same time. The results are essentially unchanged: the CAR for forced

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[27] This may not be surprising: Jiang et al. (2010) claim that abuses of "other receivables" declined after 2006 when the central government began requiring repayment of these loans.

divestitures is negatively related to the controller's cash flow rights interacted with

being forced to divest, and not reliably connected to OREC.

C. Related Party Transactions (RPTs)

We next consider direct measures of resource flows between the impacted firm and

other members of the group. The China Securities Regulatory Commission – the

Chinese equivalent to the U.S. Securities and Exchange Commission – requires

multibusiness companies to document all transactions between business units in the

group, typically referred to as "related party transactions" (RPTs) (see Jia et al. (2013)

for a detailed discussion of these transactions and Fisman and Wang (2010) for an

overview of basic patterns). We focus on two types of transaction: (i) intercorporate

loans and loan guarantees, and (ii) other transactions. "Other transactions" include

internal purchases of goods and assets, leases, and the formation of joint ventures.

Although "other transactions" involve transfers of real goods, they can have a financial

component if the price of a transfer is set above or below the market price.

RPTs provide one measure of the activity level of the internal markets for capital

and goods. As Table 2 shows, RPTs are nontrivial for sample firms, averaging 17.8

percent of assets for companies forced to divest hotel assets and 13.7 percent of assets

for companies forced to divest real estate assets. The precise interpretation of RPTs is

open to debate: while some studies consider RPTs as prima facie evidence of tunneling

(e.g. Cheung et al. (2006)), other evidence indicates that these internal transfers are used efficiently to buffer group companies from economic shocks (Gopalan et al. 2007; Jia et al., 2013). The simple correlation between the controller's cash flow rights and total RPTs is -0.16, suggesting that groups with a suspect controller use more RPTs, but the connection is modest. Our approach here is somewhat agnostic: we include RPT variables in regressions and let the data tell us how investors viewed these transactions.

Table 7 includes regressions that allow the CARs to vary with the volume of RPTs. As in the previous table, each column is a regression, and the panels differ in that panel A does not and panel B does include (unreported) control variables. Regressions (1), (2), (5), and (6), which do not include the controller's cash flow rights, provide weak and somewhat inconsistent evidence for a connection between CARs and RPTs. The coefficients on the interaction terms are positive in six of eight cases, but statistically different from zero only for loans over the [-1, 6] window. Taken at face value, the coefficient of 1.41 on the interaction term in regression (2) implies that investors favored forced refocusing when related party loans and loan guarantees were large – this would be consistent with the view of RPT loans and loan guarantees as a form of tunneling – but the coefficient is not robust.

Regressions (3), (4), (7), and (8) introduce the controller's cash flow rights. Adding this variable does not materially change the RPT coefficients, although they slightly decline in magnitude. The interaction term on the controller's cash flow rights

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remains negative and different from zero at conventional levels of statistical significance. The main message remains the same: there is some weak evidence that investors dislike RPTs, but the pattern is not robust.[28] The strongest predictor of investor reaction to forced refocusing is the cash flow rights of the controller.

There are at least two ways to interpret these findings. One view is that RPTs do not capture inefficient investment or tunneling; perhaps because firms falsify or obscure their reported RPTs (Fisman and Wang (forthcoming) provide evidence along these lines).[29] A different view is that RPTs combine both value-increasing (winner-picking and risk-pooling) and value-reducing (tunneling) transactions, and the two effects cannot be separated using aggregate numbers. In any case, the findings suggest that neither OREC nor RPTs are reliable indicators of the sort of inefficient investment and tunneling that might have motivated the market's negative view on diversification.

6. Announcement Returns and the Excess Value Construct

This focus of this paper is the value consequences of diversified business groups, but the data can also shed some light on the "excess value" construct that has been widely used in the diversification literature beginning with Lang and Stulz (1994) and Berger

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[28] We also estimated regressions that distinguished RPT flows into and out of the firm; no robust patterns emerged.

[29] A recent example is Shanhe Zhineng (stock code 002097), which was found to have hidden related party transactions in the past few years that are valued at several billion RMB (Zhu, 2014). See http://finance.qq.com/a/20140717/000769.htm for details.

and Ofek (1995). The excess value is calculated as the difference between a diversified firm's observed market value and a weighted average of the value of matched nondiversified firms in the same industries as the diversified firm's divisions. The excess value is intended to capture the value destruction due to diversification. Typically, studies have found an average excess value for diversified firms in the range of -10 to -15 percent, which has been interpreted to mean that diversified firms would be worth 10-15 percent more if they refocused. However, an extensive literature questions this interpretation, primarily out of concern that the matched nondiversified firms may not comprise an appropriate benchmark for the divisions of diversified firms. The concern has a theoretical and empirical basis: theory predicts that diversified and nondiversified firms are likely to have different capabilities and opportunities (Matsusaka, 2001; Maksimovic and Phillips, 2002), and empirical research shows that they differ on observables (Campa and Kedia, 2002; Graham et al., 2002; Villalonga, 2004a; Custodio, 2014). Some attempts to construct the excess value for American corporations after controlling for selection have produced estimates of no diversification discount or a diversification premium. One recent survey (Maksimovic and Phillips, 2007) concluded, "Much of the conglomerate discount can be explained by sample selection. Firms that choose to diversify, or to stay diversified or to be acquired by diversifiers inherently differ from single-segment firms."

The forced refocusing announcements offer an opportunity to directly assess the potential bias of the excess value measure by comparing the actual value consequence of refocusing with the value consequence implied by the excess value. The question is: how well does the excess value predict the actual value change following the announcement?[30] For the companies that were forced to refocus, we find a mean estimated excess value of -8.8 percent (median -21.8 percent) using standard methods. These numbers are comparable to findings of other studies in the literature, and under the received interpretation, imply that forcing these firms to divest their unrelated assets will increase their value by 8.8 percent on average. We know from Table 3 that the mean increase in value upon the refocusing announcement was 1 to 2 percent. Therefore, at first blush, the excess value measure appears to overstate substantially the true diversification discount.

Figure 2 plots each company's estimated excess value against its CAR from the refocusing announcement. To establish a reference point, note that if excess value was a perfect predictor of the effect of diversification on value, then the CAR should be equal to (minus) the excess value, that is, the data should be aligned along the negatively

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[30] Two previous studies report some evidence along the same lines, but only for firms that chose to refocus. Berger and Ofek (1999, Table 9) regress the abnormal return associated with a refocusing announcement on the excess value for a sample of 67-103 American corporations, and find a coefficient on excess value from -0.099 to -0.135. Interpretation is complicated by a large number of explanatory variables in the regression, many of which may impact the excess value. Dittmar and Shivdasani (2003, Table III) find that when diversified firms divest a unit, shrinking from two to one segment, the mean (median) estimated diversification discount falls from 23 (32) percent to 14 (6) percent. If accurate, the excess value should be zero after refocusing to a single segment.

sloping 45-degree line.[31] Panel A plots the comparison using the [-1, 1] event window and Panel B plots the comparison using the [-1, 6] event window. Neither figure displays a pattern close to the negative 45-degree line. Indeed, the excess value bears little relation to the CAR; the R^2 is .0003 in the top panel and .015 in the bottom panel.

There are several reasons that the excess value might fail to predict the CAR even if it did in fact capture the value consequences of diversification. First, to the extent that divestitures were delayed, the value consequences would be discounted, and the abnormal return would be lower than the estimated excess value. To get a rough sense of whether this can account for the observed patterns, suppose that divestitures were not expected to occur for the full five years and suppose the discount rate was 5 percent; then the relation between abnormal returns would be $CAR = 0.78 \times EV$. This is far from the pattern in Figure 2. Second, if the forced refocusing does not fully unravel a firm's diversification (because it operates in more than two industries), then the CAR would incorporate only a fraction of the diversification discount, and hence be smaller than the excess value. One way to assess the importance of partial refocusing is to examine the 18 firms that began with two segments, and thus were forced to fully undiversify. Those firms are indicated with blue dots in Figure 2. As can be seen, the lack of connection

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[31] This discussion assumes that investors are able to correctly value the consequences of forced refocusing. This may be a strong assumption, but it applies equally to the excess value measure and the abnormal return measure. That is, both estimates rely on the validity of the assessments of market participants; if those assessments are mistaken then neither construct is a reliable measure of the effect of diversification on value.

between excess value and CAR holds for those firms. Third, the announcement return might have been discounted by the possibility that refocusing would not take place. As a back-of-the-envelope calculation, in order for the mean excess value to correctly predict the mean announcement return, the expected probability of compliance had to have been between $\frac{1}{8.8} = .11$ and $\frac{2}{8.8} = .23$, which seems unreasonably low based on the tenor of media stories at the time. Also, even with discounting for the possibility of noncompliance, we would still expect to see a cross-sectional correlation between excess value and the announcement return, which is not apparent.

To summarize, for our sample the excess value is not an accurate predictor of the announcement return. This suggests that researchers should be cautious in using the excess value as a measure of the true diversification discount when studying business groups, unless there is some independent confirmation of its ability to predict.

7. Discussion and Conclusion

This paper reports what we believe is the first quasi-experimental evidence on how diversification affects corporate value in business groups. Unlike research using the excess value measure, our estimates do not rely on hypotheticals about how the diversified firm would be valued if it was refocused; we directly observe the value consequences of refocusing. Unlike research based on voluntary divestitures and

refocusing, our estimates are not restricted to firms that chose to refocus; in the episodes we study, all firms in the target industries were forced to refocus.[32]

The main finding is that companies that were forced to refocus experienced positive abnormal returns of 1 to 2 percent, with returns of 2.3 to 3.5 percent for nontrivial divestitures. In addition, we find that the market's reaction to forced refocusing was most positive for firms that had a controlling shareholder with limited cash flow rights, suggesting that investors were concerned with the possibility of inefficient investment or tunneling by the controlling shareholder. We do not find strong evidence linking the announcement return to reported internal transactions, however.

At first glance, our finding that investors view diversification as value destroying might seem to be at odds with a healthy body of research showing that diversified companies internally allocate resources in a manner consistent with economic efficiency; for example, Gopalan et al. (2007) show that intragroup loans in Indian business groups are used to provide financial support to weaker members in response to negative earnings shocks; Jia et al. (2013) show that Chinese business groups move

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[32] A paper close in spirit to ours is Natividad and Rawley (2013). They study the productivity of Peruvian fishing ships after the government banned mackerel fishing, forcing ships that previously fished for both anchovies and mackerel to "refocus" and specialize in anchovies. The paper finds that productivity declined in response to this form of forced refocusing. As the authors note, diversification in their industry operated primarily by providing scope economies, unlike the companies we study in which diversification operates through intercorporate resource transfers. Natividad (2013) provides quasi-experimental evidence that Peruvian fish-processing firms shift financial resources from low to high return lines of business in response to shocks.

resources within the group to buffer group members from economic shocks; and

Maksimovic and Phillips (2002) show that investment patterns in American

corporations are consistent with value maximizing principles. Our findings are not

necessarily inconsistent with the idea that some internal resource allocation follows

optimal investment principles, or with the idea that diversified groups serve to bridge

gaps in external markets; it could be that internal transfers occur for value destroying

purposes as well, and that investors view the downsides as more worrisome than the

upsides, at least for the particular firms we study. One way to bring together the

different findings in the literature is that the internal markets of these groups serve

some valuable economic purposes *and at the same time* allow controlling shareholders to

employ some corporate resources inefficiently. It may be that efficient and inefficient

transactions can coexist inside the same company or group.

A natural question is why Chinese authorities would permit CSOEs to operate

with an inefficient organizational structure? We cannot answer the question here, but

one possibility is that large, diversified groups are easier to control politically. While the

central government does not appear to be interested much in the regular operations of

the CSOEs, it does expect them to help achieve broader policy goals. For example, Deng

et al. (forthcoming) show that the central government implements monetary policy in

part by directing CSOEs to borrow and invest in order to achieve target aggregate levels

of investment. The government may be willing forego some degree of value maximization in order to advance its social goals.

The core evidence in our study comes from 50 publicly traded companies that are controlled by the central government. Even though this gives us fewer observations than a typical study of American firms, we are still able to isolate statistically precise estimates of several key coefficients. While it would be desirable to have more observations – and it would enable more texture in the analysis – it seems that research seeking to understand the Chinese economy will have to work with such limited sample sizes as long as the state-controlled sector remains important and consolidated into a relatively small number of immense companies.

Whether the paper's findings extend to diversified conglomerates such as the American corporations that have been subject of much research is unclear. The evidence seems to fit most naturally with other research on business groups in emerging economies, particularly state-owned enterprises. As discussed in the introduction, state-controlled business groups are key players in many emerging economies, and it seems important to develop a body of evidence to understand their behavior (Khanna and Yafeh, 2007). A healthy debate runs through the literature concerning the economic function of such business groups. One view is that these groups serve to internalize a variety of transactions due to institutional and legal gaps in external markets. Evidence in Allen et al. (2005) and other studies shows that market institutions are

underdeveloped in China, creating opportunities for business groups to add value through internal transactions. The contrasting view is that the internal transactions of business groups lend themselves to investment distortions and wealth transfers between controlling and non-controlling shareholders. Our evidence suggests that despite the opportunity for value gains through internal transactions, the Chinese companies in our sample were using their internal markets inefficiently on net, and reducing corporate value as a consequence.

At a broad level, our study is intended to contribute to the growing body of research that seeks to understand the performance and behavior of the Chinese economy. The organization and core elements of this enormous and dynamic economy differ from the textbook models that are most familiar and were designed to understand industrialized Western economies populated by privately owned corporations. Unlike the United States, the typical large firm in China is not characterized by widely dispersed ownership by private investors but by significant if not controlling government ownership. Understanding the extent to which our existing theories of corporate behavior do and do not extend to such enterprises is an important step in understanding the behavior of the Chinese economy overall. It is also important for thinking about the potential impact on countries outside the United States as Chinese business continue to extend their scope into other countries through acquisitions.

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Figure 1. Percent of Chinese National Output from State-Owned Enterprises
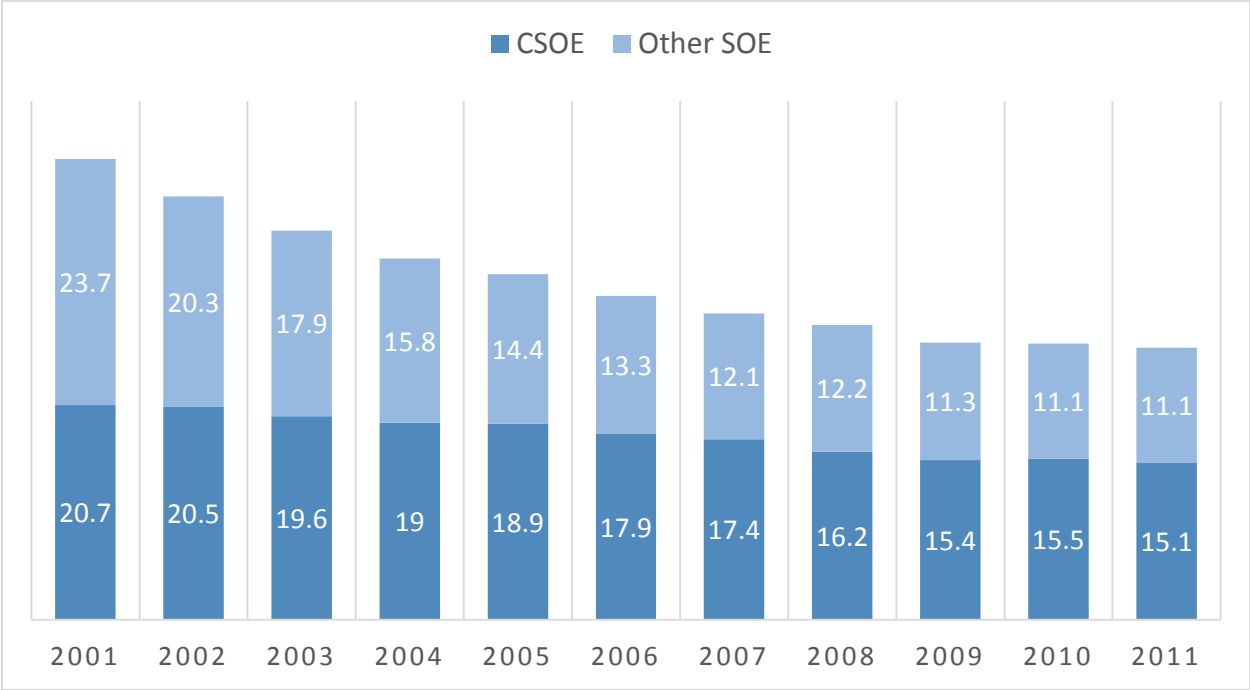
Note: CSOEs are centrally controlled state-owned enterprises. Other SOEs are provincial and locally state-owned enterprises. Data are taken from National Bureau of Statistics of China.

Figure 2. Excess Value versus Cumulative Abnormal Return from Forced Refocusing
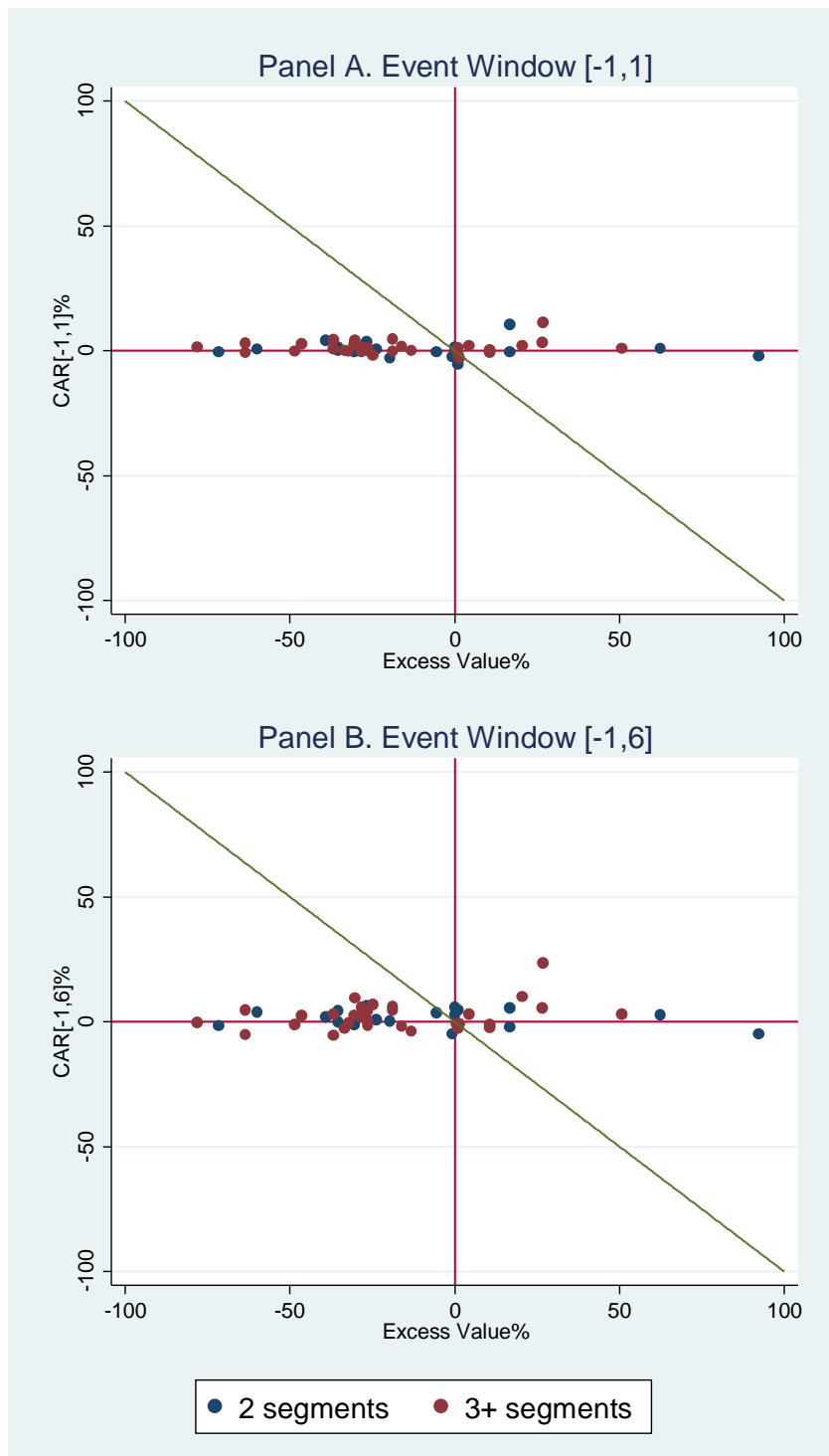
Note. The figure plots the excess value against the cumulative abnormal return (CAR) for firms that were forced to refocus. Excess value is the value of the company minus the value of a sales-weighted portfolio of single-segment firms in matching industries. Panel A and Panel B differ in the size of the event window over which the abnormal return is calculated.

Table 1. Diversification of Major Chinese CSOEs

	Fortune Global 500	Companies in group	Agriculture	Communication	Construction	Engineering	Finance	Manufacturing	Natural Resources	Oil and Gas	Public Utilities	Real Estate	Trade	Transportation
Sinopec	#3	90+			●		●	●		●			●	●
China National Petroleum	#4	120			●	●	●	●		●		●	●	
State Grid	#7	50-60			●		●				●			
CSCEC	#52	30+			●	●		●				●		
China Mobile	#55	30+		●										
CNOOC	#79	99						●		●				
China Railway Construction	#80	30+			●		●	●	●			●	●	
China Railway	#86	46			●	●	●	●	●			●	●	
Sinochem	#107	100+	●				●	●		●		●		
China Minmetals	#133	90					●	●	●			●	●	

Note. This table is based on information in Chen (2013).

Table 2. Summary Statistics

	Companies Forced to Divest Hotels	Companies Forced to Divest Real Estate	Companies Not Forced to Divest
%Sales Divested	1.53 (2.24) [0.68]	9.33 (11.51) [2.55]	...
Assets (logarithm)	23.18 (2.10) [23.53]	23.24 (2.11) [23.40]	22.37 (1.63) [22.04]
Market/Book	2.09 (1.30) [1.56]	2.07 (1.34) [1.49]	2.50 (1.25) [2.16]
ROA	0.031 (0.036) [0.031]	0.045 (0.051) [0.031]	0.030 (0.099) [0.030]
Cash/Assets	0.111 (0.124) [0.075]	0.167 (0.136) [0.141]	0.183 (0.154) [0.147]
CAPEX/Assets	0.069 (0.082) [0.048]	0.051 (0.039) [0.039]	0.057 (0.078) [0.040]
Excess Value	-0.035 (0.443) [-0.131]	-0.133 (0.419) [-0.269]	0.002 (0.474) [-0.115]
Controller's CF rights	0.374 (0.178) [0.357]	0.385 (0.160) [0.355]	0.392 (0.172) [0.400]
Other receivables/Assets	0.003 (0.007) [0.0001]	0.006 (0.016) [0.0002]	0.005 (0.032) [0.0001]
RPT_{loans}	0.102 (0.160) [0.031]	0.056 (0.133) [0.000]	0.101 (0.153) [0.028]
RPT_{other}	0.076 (0.135) [0.018]	0.081 (0.160) [0.013]	0.160 (0.304) [0.051]
Observations	23	27	217

Note. The main entry is the mean; the standard deviation is in round parentheses; and the median is in square brackets. Market/book is based on 22 observations in the forced hotel sample and 207 observations in the not forced sample. CAPEX is based on 216 observations in the not forced sample. Related party transaction (RPT) variables are expressed as a fraction of assets. All companies are CSOEs. Data sources are described in the text.

Table 3. Cumulative Abnormal Return for Companies Forced to Refocus

	Window	N	Mean		Median		Min	Max
			Value	|t|	Value	|z|		
(1) All companies required to divest	[-1, 0]	50	0.2	0.4	0.1	0.4	-5.2	9.5
	[-1, 1]	50	1.0	2.5**	0.5	2.4**	-5.5	11.4
	[-1, 2]	50	1.4	2.9***	0.6	2.7***	-3.8	12.7
	[-1, 3]	50	1.5	3.2***	1.2	2.6***	-3.4	13.3
	[-1, 4]	50	1.6	2.8***	0.9	2.3**	-4.2	18.4
	[-1, 5]	50	1.3	2.2**	0.6	1.8*	-5.1	15.5
	[-1, 6]	50	2.0	2.8***	2.1	2.6***	-5.5	23.5
(2) Companies required to divest assets > 2 percent of sales	[-1, 0]	23	0.9	1.8*	0.4	1.5	-1.6	9.5
	[-1, 1]	23	2.3	3.4***	1.8	3.4***	-1.6	11.4
	[-1, 2]	23	2.6	3.2***	2.2	2.8***	-3.2	12.7
	[-1, 3]	23	2.8	3.5***	2.3	2.8***	-2.4	13.3
	[-1, 4]	23	2.7	2.7**	1.3	2.6***	-4.2	18.4
	[-1, 5]	23	2.4	2.4**	2.6	2.2***	-4.6	15.5
	[-1, 6]	23	3.2	2.6**	3.1	2.6***	-5.5	23.5
(3) Companies required to divest hotel assets	[-1,1]	23	1.2	1.5	0.4	1.4	-5.5	11.4
	[-1, 6]	23	2.5	1.9*	2.1	1.8*	-5.5	23.5
(4) Companies required to divest real estate assets	[-1, 1]	27	0.9	2.4**	0.5	2.0**	-3.0	4.5
	[-1, 6]	27	1.5	2.2**	0.8	1.9*	-4.9	9.6

Notes. The table summarizes the cumulative abnormal return for firms during the event window of the forced refocusing announcements. Cumulative abnormal returns are expressed as percentages. The event date for the forced divestiture announcement was January 26, 2010 for hotel assets and March 18, 2010 for real estate assets. All firms are CSOEs. Significance levels are indicated: * = 10 percent, ** = 5 percent, *** = 1 percent.

Table 4. Cumulative Abnormal Return for Companies Not Forced to Divest

	Window	N	Mean		Median		Min	Max
			Value	|t|	Value	|z|		
(1) Local SOEs, main business = hotels or real estate	[-1, 1]	64	0.8	2.0**	0.3	1.7*	-6.6	11.5
	[-1, 6]	64	-0.2	0.4	-0.1	0.4	-15.4	11.4
(2) Private companies, main business = hotels or real estate	[-1, 1]	81	0.7	1.7*	0.2	1.5	-6.6	13.3
	[-1, 6]	81	-0.9	1.6	-1.5	-2.0**	-13.1	14.4
(3) CSOEs not required to divest	[-1, 1]	432	0.3	1.6	0.2	1.9*	-9.0	11.4
	[-1, 6]	431	0.0	0.1	-0.7	1.5	-12.8	23.6

Notes. The table summarizes the cumulative abnormal returns during the event window of the forced refocusing announcements for companies that were not forced to divest. Cumulative abnormal returns are expressed as percentages. The event date for the forced divestiture announcement was January 26, 2010 for hotel assets and March 18, 2010 for real estate assets. Significance levels are indicated: * = 10 percent, ** = 5 percent, *** = 1 percent.

Table 5. Regressions of Cumulative Abnormal Returns on the Size of Forced Divestitures

	Full Sample						Hotel Event		Real Estate Event	
	[-1, 1]	[-1, 6]	[-1, 1]	[-1, 6]	[-1, 1]	[-1, 6]	[-1, 1]	-[1, 6]	[-1, 1]	[1-, 6]
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
%Divested	0.09***	0.18***	0.07*	0.16**	1.12***	1.52**	1.09***	1.50**	0.06*	0.13***
	(0.03)	(0.06)	(0.04)	(0.08)	(0.22)	(0.72)	(0.21)	(0.76)	(0.03)	(0.05)
%Divested × (Dummy = 1 for real estate event)	...	...	...	...	-1.07***	-1.40*	...	...	...	...
					(0.22)	(0.72)				
Assets, log	...	...	0.10	-0.28	0.03	-0.60	0.25	-0.001	0.06	-0.29
			(0.12)	(0.20)	(0.17)	(0.26)	(0.22)	(0.41)	(0.16)	(0.26)
Market/Book	...	...	0.00	-0.63**	7.53***	7.78**	-0.16	-0.96**	0.25	-0.08
			(0.17)	(0.26)	(2.76)	(3.90)	(0.29)	(0.44)	(0.23)	(0.37)
ROA	...	...	8.03***	8.42**	-0.50	-2.38	14.68***	13.57**	0.90	1.93
			(2.84)	(3.93)	(1.26)	(2.49)	(5.01)	(6.89)	(2.77)	(5.25)
Cash/Assets	...	...	-0.65	2.18	0.63	2.71	1.89	7.54*	-2.66**	-2.43
			(1.28)	(2.45)	(2.15)	(3.46)	(2.47)	(4.35)	(1.17)	(2.67)
CAPEX/Assets	...	...	0.90	3.10	0.03	-0.60	0.35	-0.34	1.37	6.91
			(2.20)	(3.24)	(0.17)	(0.26)	(3.93)	(6.17)	(2.57)	(4.50)
Dummy = 1 for real estate event	...	...	0.06	-0.69	0.24	-0.46	...	...	...	...
			(0.33)	(0.59)	(0.32)	(0.57)				
Constant	0.28*	0.11	-2.20	7.63	-3.82	5.51	-6.43	0.79	-1.02	6.77
	(0.15)	(0.24)	(2.95)	(4.91)	(2.89)	(5.05)	(5.39)	(9.77)	(3.79)	(6.36)
2-digit industry fixed effects	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R²	.010	.013	.120	.090	.154	.110	.289	.245	.211	.213
Observations	482	482	465	464	465	464	234	234	231	230

Note. Each column reports a regression in which the dependent variable is the cumulative abnormal return, expressed as a percentage. The size of the event window and sample are indicated at the top of each column. Standard errors (clustered at the firm level in the full sample) are reported in parentheses beneath the coefficient estimates. "%Divested" is the percent of sales produced by the unit(s) to be divested; it is equal to zero for firms with no real estate or hotel assets. The sample includes all publicly traded CSOEs, that is, those that were and were not required to divest by the refocusing order. Significance levels are indicated: * = 10 percent, ** = 5 percent, *** = 1 percent.

Table 6. Regressions of CARs on Controller Cash Rights and Other Receivables

	[-1, 1]	[-1, 6]	[-1, 1]	[-1, 6]	[1, 1]	[-1, 6]
Panel A. Regressions without Control Variables						
	(1)	(2)	(3)	(4)	(5)	(6)
%Divested	0.26***	0.64***	0.08*	0.17**	0.26***	0.64***
	(0.09)	(0.18)	(0.04)	(0.08)	(0.09)	(0.19)
Controller's CF right	1.00	0.92	...	...	0.98	0.85
	(0.83)	(1.69)			(0.83)	(1.69)
Controller's CF right × %Divested	-0.53**	-1.38***	...	...	-0.53**	-1.37***
	(0.22)	(0.47)			(0.22)	(0.47)
OREC	...	...	-2.73	-4.16	-2.50	-3.95
			(1.98)	(4.29)	(1.95)	(4.30)
OREC × %Divested	...	...	1.95	-9.78	2.61	-8.54
			(4.49)	(12.17)	(3.65)	(9.54)
R²	.104	.076	.099	.067	.105	.077
Observations	482	481	482	481	482	481
Panel B. Regressions with Control Variables						
	(7)	(8)	(9)	(10)	(11)	(12)
%Divested	0.26**	0.58***	0.07*	0.17**	0.26**	0.58***
	(0.10)	(0.19)	(0.04)	(0.08)	(0.10)	(0.20)
Controller's CF right	0.81	0.18	...	...	0.81	0.20
	(0.99)	(1.60)			(1.00)	(1.61)
Controller's CF right × %Divested	-0.54**	-1.22**	...	...	-0.54**	-1.22**
	(0.24)	(0.50)			(0.24)	(0.50)
OREC	...	...	-1.12	3.12	-0.92	2.97
			(2.78)	(4.94)	(2.80)	(5.01)
OREC × %Divested	...	...	1.56	-10.27	2.17	-9.42
			(6.05)	(12.75)	(5.13)	(10.53)
R²	.125	.098	.120	.091	.125	.099
Observations	465	464	465	464	465	464

Note. Each column in each panel reports a regression in which the dependent variable is the cumulative abnormal return, expressed as a percentage, over the event window indicated at the top of the column. %Divested is the percentage of sales accounted for by the unit to be divested. Controller's CF Rights is percentage of firm's cash flow that the controller owns. OREC is other receivables with respect to the controller divided by assets. Panel A regressions include a dummy for the real estate event and 2-digit industry fixed effects. Panel B regressions include a dummy for the real estate event, 2-digit industry fixed effects, log of assets, market to book, ROA, cash as a fraction of assets, and CAPEX as a fraction of assets. Standard errors clustered at the firm level are reported in parentheses beneath the coefficient estimates. Significance levels are indicated: * = 10 percent, ** = 5 percent, *** = 1 percent.

Table 7. Regressions of CARs on Related Party Transactions (RPTs)

	[-1, 1]	[-1, 6]	[1, 1]	[-1, 6]
Panel A. Regressions without controls	(1)	(2)	(3)	(4)
%Divested	0.01	0.04	0.14*	0.56***
	(0.04)	(0.11)	(0.08)	(0.11)
RPT_{loans}	-2.16*	0.11	-2.10*	0.22
	(1.11)	(1.98)	(1.11)	(1.98)
$RPT_{loans}\times$ %Divested	0.40	1.41*	0.31	1.05
	(0.42)	(0.78)	(0.40)	(0.66)
RPT_{other}	-0.29	-0.65	-0.25	-0.58
	(0.39)	(0.65)	(0.39)	(0.65)
RPT_{other} x %Divested	0.72	-0.64	0.62	-1.19
	(0.89)	(0.85)	(0.92)	(0.93)
Controller's CF rights	...	...	0.90	0.67
			(0.83)	(1.70)
Controller's CF rights x %Divested	...	...	-0.33*	-1.34***
			(0.18)	(0.33)
R²	.113	.074	.115	.083
Observations	482	481	482	481
Panel B. Regressions with controls	(5)	(6)	(7)	(8)
%Divested	-0.01	0.01	0.13	0.46***
	(0.04)	(0.10)	(0.08)	(0.12)
RPT_{loans}	-1.07	1.64	-1.03	1.71
	(1.14)	(1.84)	(1.15)	(1.85)
$RPT_{loans}\times$ %Divested	0.49	1.58**	0.39	1.29**
	(0.44)	(0.72)	(0.41)	(0.63)
RPT_{other}	-0.52	-0.48	-0.49	-0.48
	(0.44)	(0.66)	(0.44)	(0.67)
RPT_{other} x %Divested	0.70	-0.77	0.57	-1.26
	(0.93)	(0.84)	(0.95)	(0.91)
Controller's CF rights	...	...	0.65	-0.12
			(1.01)	(1.61)
Controller's CF rights x %Divested	...	...	-0.34*	-1.14***
			(0.18)	(0.33)
R²	.130	.102	.132	.108
Observations	465	464	465	464

Note. Each column in each panel reports a regression in which the dependent variable is the cumulative abnormal return, expressed as a percentage, over the event window indicated at the top of each column. %Divested is the percentage of sales accounted for by the unit to be divested. RPT is related party transactions. Controller's CF Rights is the percentage of cash flow owned by the controller. Panel A regressions include a dummy for the real estate event and 2-digit industry fixed effects. Panel B regressions include a dummy for the real estate event, 2-digit industry fixed effects, log of assets, market to book, ROA, cash as a fraction of assets, and CAPEX as a fraction of assets. Standard errors clustered at the firm level are reported in parentheses beneath the coefficient estimates. Significance levels are indicated: * = 10 percent, ** = 5 percent, *** = 1 percent