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Does diversification caused internal capital market inefficiency?

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This paper investigates the effect of adding new segments on the internal capital market. Previous literature usually examine the relationship of decreasing segments and internal capital market and find that internal capital market becomes more efficient as firms spin off segments that did poorly. This paper examine if the internal capital market are less efficient after firm add new segments. It is demonstrated that for diversified firms, there is a strong and significant negative relationship between the number of segments and the diversity in investment opportunities. Previous literature show that it is the diversity in investment opportunities that drives the internal capital market inefficiency, this implies that firms with more segments may have a more efficient internal capital market than firms with fewer segments. The results of this paper show that after firms add new segments, firm size increases, profitability ratio decreases, leverage increases and diversity measure decreases. There are no significant changes in excess value, relative excess investment and efficiency of investment allocation. The change in excess value is negatively related to diversity measure, implying the firms have biggest decrease in diversity after being more diversified have largest increase in excess value.