

Diversification and Financial Performance in Bursa Malaysia

^{1*} M. Doaei, ² M. Ahmad Anuar, ³ Z. Ismail

^{1,2} Faculty of Management, University of Technology Malaysia, Skudai, Johor Bahru, Malaysia

³ Faculty of Science, University of Technology Malaysia, Skudai, Johor Bahru, Malaysia

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ABSTRACT:

Firms pursue diversification for sake enhancing financial performance. Some theories state positive relationship between diversification and financial performance. However, there are some theories for negative relationship about the issue. The study has filled the gap that most studies done in developed countries and there are fewer studies in developing country like Malaysia. In this study, researchers try to examine the relationship between product diversification and international diversification with financial performance in manufacturing firms listed in Bursa Malaysia. The study is done in 102 manufacturing firms listed in Bursa Malaysia during 2006 to 2010. Two regression models are run with return on assets (ROA) as a dependent variable. Also, the main independent variables are total product diversification (TPD), related product diversification (RPD), unrelated product diversification (UPD), international diversification (ID). The results show product diversification and unrelated diversification are not significant; however, related diversification and international diversification have negative impact on financial performance.

Keywords: *Product diversification, International diversification, Related diversification, Unrelated diversification financial performance*

INTRODUCTION

Corporate diversification has been significant issue in the modern business world (Cernas Ortiz, 2011). This issue has an impact on firm's financial performance. However, there is no agreement about the negative, positive or neutral impact (Patrick, 2012). Moreover, firms in emerging market may be justified to have wider scope because market failures are more prevalent in these economies (Khanna and Palepu, 2000; Khanna and Rivkin, 2001; Lins and Servaes, 2002). Furthermore, listed firms in Bursa Malaysia are likely to be diversified and Claessens et al. (2001; 2003) stated that approximately 70%, Ishak and Napier (2004; 2006) said 55% of firms are diversified in Bursa

Malaysia. Finally, regarding the high rate of number of diversified firms in Bursa Malaysia, we'd like to do the study about corporate diversification and financial performance in manufacturing firms listed in Bursa Malaysia.

The study has filled the gap that most studies done in developed countries and there are fewer studies in developing country like Malaysia. In addition, other related research was conducted by cross sectional methodology; however, we have used panel data technique. The most important issue is that we examine product diversification (as related and unrelated) and international diversification together which had less attention in previous research.

*Corresponding Author, Email: dmeysam2@live.utm.my

The structure of the paper is as follows. The next section develops hypothesis under study through a review of the related literature. Section 3 contains the data and empirical methodology. Section 4 and 5 report results and discussion. The final section offers some concluding remarks, limitation and future studies.

Literature Review

Before describing literature review, the study should be explained some theories behind why firm diversify. The related theories are as agency theory, free cash flow theory, efficiency theory, resource based theory and market power theory. All the theories are explained by Doaei et al. (2012). As a brief, the negative impact of diversification on financial performance are stated as agency theory (Jensen and Meckling, 1976) and free cash flow theory (Jensen, 1986) and the positive effect are described as resource based theory (Penrose, 1959) and market power theory (Edwards, 1955).

Next part discusses some significant researches from developed and developing countries based on findings.

Studies on Developed Countries

Rumelt (1974; 1982) is one of first researcher stated that related diversification makes more profit than unrelated diversification, because firms in related form can transfer core competencies. Caper and Kotabe (2003) ascertained that there was a curvilinear relationship between multinationality and performance in German service firms. Jung and Chan-Olmsted (2005) found out a positive relation between related product and international diversification and financial performance among media firms in United States. In addition, they concluded the more related product and international diversification, the more financial performance.

Brammer et al. (2006) investigated between corporate social performance and geographical diversification on a sample of large UK firms. They found out evidence of a significant positive relationship between the two for some types of social performance and in some regions of the world. Qian et al. (2008) examined on largest US firms during the years 1996-2000 that how regional (international) diversification affects firm performance. The results indicated that

regional diversification has linear and curvilinear effects on firm performance. Regional diversification enhances firm performance linearly up to a certain threshold, and then its impact becomes negative. Bobillo et al. (2010) examined the association between international diversification and firm performance. Based on a sample of manufacturing firms in five countries, the results showed that the mix of internal and external competitive advantages affected the relation between international diversification and firm performance.

Kahloul and Hallara (2010) studied the relationship between diversification, performance and risk in 69 French large firms between 1995 and 2005. As a result, they found that there is no relationship between diversification and performance. In addition, there is no linear relation between total risk and diversification. Muñoz-Bullón and Sanchez-Bueno (2011) rely on small and medium (SME) manufacturing firms from Spanish over the years 1993 to 2006. They reported a negative association between geographic market expansion and profitability. Therefore, the adoption of corporate diversification (product and international) is not related with higher performance.

Chen and Yu (2011) developed several hypotheses based on the agency theory and tests the relationships among managerial ownership, corporate diversification, and firm performance using a sample of 98 firms listed on the Taiwan Stock Exchange. The results show a U-shaped relationship between managerial ownership and corporate diversification.

Oyewobi et al. (2013) have examined impact of business diversification on South African construction firms' corporate performance. They found that established construction firms on the contractor registers perform and diversify more in their service/product better than the newly upgraded contractors and this was evident in their performance with respect to profit margin.

Studies on Developing Countries

Lins and Servaes (2002) done their studies in one thousand firms from some emerging markets such as Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, and Thailand in 1995. They found diversified firms less profitable than focus firms. Ahmad et al. (2003) started a

research on corporate diversification in Malaysia. They investigated the relationship between corporate governance, ownership structure and corporate diversification in Bursa Malaysia. They found out there is not a significant relationship between managerial ownership and diversification although the directions were generally as expected. Therefore, they concluded good corporate governance was shown to reduce corporate diversification activities.

Clasessens et al. (2003) have done a research on corporate diversification in South Korea, Japan and seven east Asian countries as Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Taiwan and Thailand during the years 1991 to 1996. They found out, except for Japanese firms, vertically integrated firms experience poor performance both in the short- and the long-term. By contrast, firms exploring complementary diversification are generally associated with positive short- and long-term performance.

Some researchers found out not only diversification do not reduce the firm value, but also value increases when the level of diversification increases (Ishak and Napier, 2006). They examined on ownership structures and corporate diversification on 355 Public Listed firms in Malaysia. They showed more than half of the firms analyzed were diversified. However, the results of the research provided no evidence that diversified firms in Malaysia are valued differently from focused firms. The finding was inconsistent with the argument that diversification reduces the value of firms.

Chakrabarti et al. (2007) examined the effect of corporate diversification on performance for some firms acting in stable period and economy shock. They did their research in six Asian countries between 1988 and 2003. They concluded that diversification has a negative effect on performance in more developed institutional environments; although, in least developed environments there is an improving performance.

Other researchers examined diversification and performance of 70 Malaysian firms from years 2001 to 2005 (Daud et al., 2009). They

showed firms with focused strategy can achieve high performance and financial ratio is affected by risk and size of firms. In addition, firms at low risk usually get high returns.

Regarding on above literature, there are two hypotheses:

Hypothesis 1- The product diversification and international diversification have a negative impact on financial performance.

Hypothesis 2- The related and unrelated product diversification and international diversification have negative impact on financial performance.

RESEARCH METHOD

The study is done on manufacturing listed firms in Bursa Malaysia due to the significant role of manufacturing sector in Malaysian economy (Mahmood, 2000; Tsen, 2005). The 102 manufacturing firms are collected from the database of Capital IQ during 2006 to 2010. A short research time is acceptable because strategy of firms change sometimes and very long period causes to reduce the number of firms with a fix strategy.

Variables

There are eleven variables in this study as table 1 shows.

RESULTS

The data set included 102 manufacturing firms, with 510 observations. As shown in table 2, the mean of product diversification is about 0.35, related diversification entropy is 0.23, and unrelated diversification entropy is 0.12. Thus, manufacturing firms are slightly more related diversified. The maximum amount of unrelated product diversification, related product diversification, total product diversification and international diversification are respectively 1.1, 1.86, 1.97 and 1. In addition, the minimum ratio of leverage is 0.03 and the maximum is 0.82. Furthermore, the maximum size of firm is 4.11. table 3 provides the correlation matrix of all tested variables. Clearly, there are high correlation between TPD and RPD (0.87), and leverage and liquidity (-0.69).

Table 1: Variable measurement

Name of Variable	Symbol	Kind of Variable	How measure
total product diversification	TPD	Independent Variables	$E = \sum_{i=1}^n P_i \ln(1/P_i)$ (6)
related-product diversification	RPD	Independent Variables	Where, P_i , ($i = 1, \dots, n$) is the share sale of segment i in total sales of the firm and n is the number of firm's segments
unrelated-product diversification	UPD	Independent Variables	
international diversification	ID	Independent Variables	The ratio of foreign sales to total sales.
ROA	ROA	Dependent Variable	$ROA = \frac{Net\ Income}{Total\ Assets}$
size	Size	Control Variable	The logarithm of total sales
age	Age	Control Variable	The logarithm of the years since its establishing
leverage	leverage	Control Variable	The ratio of total assets minus total equity to total assets
liquidity	liquidity	Control Variable	The ratio of current assets divided by current liabilities
Exchange rate	EX	Control Variable	The growth rate of the U.S. dollar-ringgit exchange rate during a year
Crisis	Crisis	Control Variable	The crisis equals one for crisis period and zero for normal years.

Table 2: Summary of descriptive statistics

	UPD	RPD	TPD	ID	Leverage	SIZE	ROA	Liquidity	AGE
Mean	0.12	0.23	0.35	0.21	0.38	2.36	28.22	2.95	3.24
Median	0.00	0.06	0.20	0.12	0.38	2.26	30.48	1.80	3.37
Maximum	1.10	1.86	1.97	1.00	0.82	4.11	79.50	34.70	5.18
Minimum	0.00	0.00	0.00	0.00	0.03	1.01	1.00	0.14	0.69
Std. Dev.	0.19	0.32	0.39	0.24	0.18	0.55	10.76	3.80	0.68
Sum	61.88	119.22	179.63	105.18	193.60	1205.99	14393.73	1504.96	1654.46
Sum Sq. Dev.	19.12	52.97	78.14	29.94	16.02	153.75	58877.38	7360.20	232.68
observations	510.00	510.00	510.00	510.00	510.00	510.00	510.00	510.00	510.00

Table 3: The correlation matrix of variables

	UPD	TPD	Leverage	SIZE	RPD	ID	ROA	AGE	Liquidity
UPD	1.00								
TPD	0.57	1.00							
Leverage	0.06	0.19	1.00						
SIZE	0.07	0.17	0.19	1.00					
RPD	0.11	0.87	0.18	0.16	1.00				
ID	-0.10	0.14	0.05	-0.01	0.23	1.00			
ROA	-0.13	-0.14	0.07	0.11	-0.10	-0.13	1.00		
AGE	0.11	0.01	-0.07	0.20	-0.06	-0.05	0.05	1.00	
Liquidity	-0.09	-0.23	-0.69	-0.28	-0.22	-0.07	-0.01	0.04	1.00

Therefore, two regression models are developed for hypothesize as:

Equation 1 The First Regression Model

$$ROA_{it} = \alpha + \beta_1 TPD_{it} + \beta_2 ID_{it} + \beta_3 size_{it} + \beta_4 age_{it} + \beta_5 leverage_{it} + \beta_6 liquidity_{it} + \beta_7 EX_t + \beta_8 Crisis_t + \varepsilon_{it}$$

Equation 2 The Second Regression Model

$$ROA_{it} = \alpha + \beta_1 RPD_{it} + \beta_2 UPD_{it} + \beta_3 ID_{it} + \beta_4 size_{it} + \beta_5 age_{it} + \beta_6 leverage_{it} + \beta_7 liquidity_{it} + \beta_8 EX_t + \beta_9 Crisis_t + \varepsilon_{it}$$

For testing the panel models, OLS, fixed effect and random effect are done. Then, the likelihood and Hausman test are evaluated and fixed effect model is confirmed for both two regressions. The results are shown on table 4. In addition, diagnostic test for autocorrelation and heteroskedasticity are done. Bhargava et al. (1982) suggest Durbin-Watson test for

autocorrelation in the residuals for balanced panel data. Once a value is near 2, it means that there is no autocorrelation in the sample. So, there are not autocorrelation in the regression models. In addition, Greene (2003) defines the modified Wald statistic for heteroskedasticity in the residuals of a fixed-effect regression model. The results show that residuals are heteroskedastic. Then, the generalized least squares (GLS) estimator are run and the residuals will be homoskedastic (table 5).

Table 5 shows, in first regression model, TPD are not significant at 5%. It means there is no relationship between TPD and ROA. However, ID has a negative impact on ROA. Control variable such as size and leverage are not significant at 5%, and age and liquidity has a positive, and ex and crisis has a negative impact on ROA.

In second model, RPD and liquidity are not significant, ID and age are significant in 1%, UPD, size, leverage, ex and crisis are significant at 5%. The negative impact of financial crisis and exchange rate on financial performance are supported.

Table 4: The regression model

	First Model		Second Model	
	Coefficient	Prob.	Coefficient	Prob.
Constant	175.51	0.00	175.67	0.00
RPD			-3.55	0.22
UPD			-7.31	0.09
TPD	-4.95	0.02		
ID	-9.42	0.00	-9.48	0.00
SIZE	4.43	0.26	4.35	0.27
AGE	-49.37	0.00	-49.39	0.00
leverage	10.58	0.14	10.46	0.14
liquidity	0.56	0.17	0.60	0.15
EX	-0.45	0.00	-0.46	0.00
CRISIS	-1.30	0.23	-1.29	0.23
Panels	Fixed effect		Fixed effect	
Adjusted R-Squared	0.47		0.47	
Prob (F-statistics)	0		0	
Durbin Watson statistics	2.3		2.3	
Wald test	heteroskedastic		heteroskedastic	

Table 5: The GLS model

	First Model		Second Model	
	Coefficient	Prob.	Coefficient	Prob.
RPD			-2.05	0.13
UPD			-7.41	0.001
TPD	-3.67	0.17		
ID	-2.3	0	-3.14	0.07
SIZE	2.9	0.14	2.82	0
AGE	0.92	0.04	1.08	0.086
leverage	6.57	0.13	6.38	0.048
liquidity	0.36	0.001	0.36	0.131
EX	-8.4	0	-0.3	0
CRISIS	-20.8	0	-8.45	0

DISCUSSION

Regarding second regression model, once firms doing corporate diversification (product and international), may they get better performance than firms do not (Muñoz-Bullón and Sanchez-Bueno, 2011). However, expanding in new segments and nations may also suggest a decrease in performance. Additionally, the expanding may be happened to follow the personal objectives by managers, as an illustration for reduction of employment risk or getting more bonuses at sacrifice of firm's profitability and growth (Seth et al., 2000; Kim et al., 2004).

As regards table 5, TPD (independent variable) is not significant in the first regression model. However, international diversification is significant and has a negative impact on financial performance. Despite that corporate diversification (product and international) normally have a positive effect on a firm's performance as expressed by some scholars such as (Kim et al., 1993), Delios and Beamish (2001), Jung and Chan-Olmsted (2005) and Chang and Wang (2007).

About the second hypothesis, theoretical arguments, whether related and unrelated diversification as a profitable strategy is contradictory. Generally, Rumelt (1974; 1982) claims related diversification makes more profits than unrelated diversification, because related diversification can transfer core tangible and intangible capabilities such as product lines, knowledge, skills, and experience into the diversifying target business (Penrose, 1959; Rumelt, 1974). Likewise, many researchers have stated that related diversification improves more profits than unrelated diversification (Bettis, 1981; Lecraw, 1984; Palepu, 1985; Lubatkin and Rogers, 1989). However, the second regression model indicates related product diversification is not significant and there is not a relationship between related product diversification and financial performance among manufacturing firms listed in Bursa Malaysia.

In comparison, some researchers find out the more doing unrelated diversification from its core business, the more performance will gain (Christensen and Montgomery, 1981; Bettis and Mahajan, 1985). However, the second regression

model shows unrelated product diversification has negative impact on financial performance among manufacturing firms listed in Bursa Malaysia. the next important variable is international diversification which has negative impact on financial performance same as previous research such as Michel and Shaked (1986), Geringer et al. (2000) and Denis et al. (2002). Therefore, the whole second hypothesis does not support.

CONCLUSION

The research tries to look into two main issues in manufacturing firms listed in Bursa Malaysia. The first is that examining the relationship between corporate (product and international) diversification and financial performance. Secondly, product diversification is evaluated as related and unrelated diversification. The results show that product diversification and unrelated diversification are not significant; however, related diversification and international diversification are significant and have negative impact on financial performance.

As other studied, there are some limitations in this research. First of all, the data for manufacturing firms during five years are not available. Secondly, measuring all financial performance indicators and considering in regression model is not possible.

For future studies, researchers should find a method for evaluating more financial performance dimension, because considering just ROA as financial performance is not reliable. In addition, we suggest that researchers to conduct a study in this issue between manufacturing firms and other sectors in Bursa Malaysia. Finally, due to high rate of diversification degree among firms in Bursa Malaysia, it is good research area for comparing with other stock exchanges.

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