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Managerial ownership, diversification, and firm performance: Evidence from an emerging market

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ABSTRACT

Numerous existing studies have explored the impact of corporate diversification on firm performance, whereas considerably less research has investigated the inter-relationships among managerial ownership, diversification, and firm performance. This paper develops several hypotheses based on the agency theory self-interest perspective and tests the relationships among managerial ownership, corporate diversification, and firm performance using a sample of 98 emerging market firms listed on the Taiwan Stock Exchange. The results show a U-shaped relationship between managerial ownership and corporate diversification, similar to that found in prior studies. However, the inflection point is 33.17%, which is lower than that found in previous studies. Moreover, in contrast to prior results, corporate diversification is found to be positively associated with short-term firm performance and bears no relationship with mid-term firm performance, while firms engaged in unrelated diversification outperform those engaged in related diversification. This paper concludes with theoretical implications and suggestions for future research.

1. Introduction

Diversification is one significant method that firms use to maintain their competitiveness and enhance their profitability. Firms seek diversification strategy in order to achieve value creation through economies of scope, financial economies, or market power (Barney, 1991; Bettis, 1981; Montgomery, 1985; Prahalad & Hamel, 1990). On the other hand, diversification can also increase costs due to difficulties associated with coordination, information asymmetry, and incentive misalignment between headquarters and divisional managers in multidivisional firms (Denis, Denis, & Yost, 2002; Harris, Kriebel, & Raviv, 1982). The relationship between diversification strategy and performance has been the focus of extensive research within the strategic management literature. Most previous work focusing on developed market firms (Amihud & Lev, 1981; Berger & Ofek, 1995; Denis, Denis, & Sarin, 1997; Denis et al., 2002; Rumelt, 1974) and limited work focusing on emerging market firms (e.g., Delios, Zhou, & Xu, 2008) have offered evidence that diversification results in worse performance for the diversifying firms. These studies signify the importance of the diversification strategy on firm profitability. However, compared to more developed markets, comparatively immature industries and less-developed capital markets within emerging markets offer firms ample opportunities and benefits to engage in diversification (Chen & Ho, 2000; Chow, Chen, & Chen, 1996; Delios, Zhou, et al., 2008; Tam & Tan, 2007). As such, firms in countries with less-developed capital markets

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should have a greater incentive to diversify in order to gain proportionally greater benefits from internal capital markets (Shackman, 2007). Therefore, the special contexts in emerging markets may represent a different form of linkage between diversification and firm performance.

The concentration of a firm's ownership structure and the identity of its owners influence a firm's corporate governance, strategies, and performance (Shleifer & Vishny, 1994). Firms in developed markets such as the US have widely dispersed ownership structures along with comparatively better corporate governance (i.e., strong investor protection mechanisms). This ownership structure illustrates the agency problem between managers and shareholders. Studies examining the managerial ownership-corporate diversification link assume that high managerial ownership promotes incentive alignment, which is therefore negatively associated with the level of corporate diversification (e.g., Chen & Ho, 2000; Delios, Zhou, et al., 2008; Denis et al., 1997; Goranova, Alessandri, Brandes, & Dharwadkar, 2007). Thus, existing studies based on firms in developed markets support a cross-sectional negative "linear" relationship between managerial ownership and diversification. However, the special contexts surrounding ownership structure and corporate governance in emerging markets may lead to a different relationship between managerial ownership and corporate diversification as compared to that found in developed markets.

Unlike firms in developed markets, the ownership structure in emerging markets such as Taiwan is characterized by the dominance of one primary owner and widely dispersed individual investors (Claessens, Djankov, & Lang, 2000; Yeh, Lee, & Woidtke, 2001). The dominant owner, typically a founder or a founding family, holds a significant number of shares—enough to be the largest shareholder but usually much less than the majority holdings of a company—and controls the company. Family firms, owned and run by one family or by a small number of families (Stern, 1986), are prominent in emerging markets, including Asia (Claessens, Djankov, Fan, & Lang, 2002), and more specifically China (Delios, Wu, & Zhou, 2006), South Korea (Jung & Kwon, 2002), Malaysia (Tam & Tan, 2007), Indonesia (Lukviarman, 2004), and Taiwan (Claessens et al., 2000; Yeh et al., 2001). These family owners usually participate in the management of the firm, directly or indirectly, and influence most managerial decisions. In other words, emerging market firms illustrate an exception to normative prescriptions regarding the separation of ownership and management and the professionalization of top management (Chen, 2001; Peng, Au, & Wang, 2001). For example, Chinese family firms often select a CEO from family members or friends so as to maintain close operational control as well as existing connections with government officials and other key resource providers (Ahlstrom, Young, Chan, & Bruton, 2004; Chen, 2001; Lien, Piesse, Strange, & Filatotchev, 2005). Claessens et al. (2000) examined nine East Asian countries and found a predominance of family control and family management. They also found that management in approximately 80% of Taiwanese listed firms is from the controlling family.

Moreover, emerging markets generally suffer from a lack of shareholder and creditor protection and have poorly developed legal systems (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Inadequate or weak corporate governance allows owners-managers to utilize free cash flows without adequate controls. Therefore, the agency problem that exists in emerging markets is not between owners and managers, as in Anglo-Saxon countries, but between controlling shareholders and minority shareholders. The different contexts in ownership structure and corporate governance associated with emerging markets firms and their effects on the level of corporate diversification are likely to differ from what is common for US firms. This highlights the necessity of examining the relationship between managerial ownership and corporate diversification for emerging market firms.

The existing literature on corporate diversification is based mainly on US data, which may only reflect US corporate behaviors and the US capital market environment. Very little is known about corporate governance (managerial ownership), corporate diversification, and firm performance outside the US, and even less for emerging markets (e.g., Delios, Zhou, et al., 2008). Emerging markets such as Taiwan provide "an excellent laboratory" to study the relationships between managerial ownership and corporate diversification and between corporate diversification and firm performance given the special contexts characterized by concentrated family-controlled ownership, widely held individual investors, limited investor protection, underdeveloped capital markets, and greater market potential. Further, previous studies have produced varied findings concerning the relationship between diversification strategy and performance (Berger & Ofek, 1995; Chen & Ho, 2000; Christensen & Montgomery, 1981; Delios & Beamish, 1999; Delios, Xu, & Beamish, 2008; Khanna & Palepu, 2000; Michel & Shaked, 1984). One explanation for these varied findings is based on the nature of the sample firms examined. First, as indicated above, the linkages between diversification strategies and other variables may differ for firms in developed markets and those in emerging markets. Second, because firms may increase their level of diversification in one year but decrease their level of diversification in the next year, any assessment of the impact of diversification on performance for a particular year must take these fluctuations into account. To the best of our knowledge, no studies have attempted to examine the relationship between corporate diversification and firm performance for emerging market firms that only increased or decreased the level of corporate diversification once over a certain period of time.[2] Only by examining firms of this nature can we consistently assess the impact of diversification and performance. To contribute to the existing literature,

[2] We would like to distinguish our work from previous studies (Denis et al., 1997; Goranova et al., 2007) that used large-sized US firms as their sample to explore the "linear" relationship between managerial ownership and diversification without purifying the sample (in terms of increased/decreased diversification). On the contrary, the current paper chooses firms from emerging markets that only increased or decreased the level of corporate diversification once over a certain period of time as the sample, and uses the self-interest perspective of agency theory to explore the "nonlinear" relationship between managerial ownership and diversification. Part of the rationale for selecting a purified sample is to avoid the problem of using firm profitability to estimate firm performance when multiple diversification and divesture announcements occur within a short period of time.