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# Does diversification add firm value in emerging economies? Effect of corporate governance ☆

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ABSTRACT

Using 205 Taiwanese firms spanning five years, this research examines how corporate governance factors specific to emerging economies determine the extent of diversification and moderate its performance. The analyses reveal that controlling family ownership is significantly associated with a greater extent of diversification, which impairs firm value. Conversely, domestic bank ownership significantly decreases diversification, which in turn increases diversification performance. These findings present the evidence of controlling family entrenchment through diversification and the significant role domestic banks play in the principal–principal corporate governance framework.



## 1. Introduction

Diversification and its effects on performance have attracted a great deal of attention in various business research disciplines. While early studies recognized the value of diversification in creating a multi-divisional structure to reduce search and coordination costs and thereby ensure the efficient exploitation of market opportunities (Chandler, 1962), later studies have reached a consensus that excessive diversification impairs firm performance (Hoskisson, Hitt, Johnson, & Moesel, 1993).

However, a common feature in emerging economies where some highly successful conglomerates operate in many unrelated sectors defies the well-established view on the negative effects of diversification (Yiu, Bruton, & Lu, 2005). More interestingly, many of these highly diversified firms are family-owned and controlled, even though they may have been successfully listed in the public market (Filatotchev, Lien, & Piesse, 2005). These observations motivate several interesting questions: why extensive diversification exists in emerging economies? Does diversification enhance or dissipate firm value? What are the roles of the controlling family and other block shareholders in firms' diversification strategy and performance?

Based on the context of specific institutional environment of emerging economies, this study addresses these questions by examining how corporate governance mechanisms influence the diversification strategy and outcome. Specifically, by integrating the institutional perspective with agency theory, this research proposes that diversification can be an effective strategy to respond to the institutional imperfections in emerging economies and thus may enhance an organization's performance up to the point of its resource constraint, beyond which diversification dissipates value. In addition, block shareholders of firms in emerging economies may be influenced by their private interests in participating in formulating diversification strategies, resulting in agency problems and leading to negative diversification performance.

## 2. Theory and hypothesis development

### *2.1. Corporate governance and firm diversification in emerging economies*

Compared with that in the advanced economies, firm diversification in emerging economies tends to be an aggregation of wide-ranging activities, in which firms extend their operations to markets that are technologically unrelated to their core business or to markets that do not require any special technological skills (Ungson, Steers, & Park, 1997). A main reason for this is that in emerging economies diversification strategy effectively complements the imperfections in the institutional environment and therefore the strategic outcome would be more beneficial than in advanced economies (Bergh and Lawless, 1998).

By simultaneously considering both the costs and the benefits of internalization, scholars have tried to determine an optimal level of a firm's diversification, where the marginal cost to increase one unit

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(i.e., one product line) of diversification equals the marginal benefit. When the firm's diversification exceeds the optimal level, the marginal cost will outweigh the marginal benefit, resulting in an "*inverted U*" effect of diversification level on firm performance. However, despite the fact that the institutional immateriality of emerging economies provides greater opportunities for diversification, many companies simply diversify over the optimal level, resulting in the negative effect of diversification that destroys shareholders' wealth (Martin & Sayrak, 2003).

### *2.2. Controlling family and diversification decisions*

Studies show empirically that the majority of firms in emerging economies are controlled by a dominant family (Claessens, Djankov, & Lang, 2000), whose ownership has unique effects on corporate governance. Specifically, evidence shows that the family ownership concentration aligns private interest of the controlling family with corporate goal of profit maximization, and thus mitigates the agency problem (Lien, Piesse, Strange, & Filatotchev, 2005). In addition, family control stimulates "family altruism" in business management that facilitates the resource commitment of the controlling family to the firm (Chrisman, Chua, & Sharma, 2005) and facilitates long-term strategic decisions by the family (Strange, Filatotchev, Lien, & Piesse, 2009).

Furthermore, driven also by the altruism to preserve interests for next generations, controlling family entrenchment may be linked with diversification strategies. To preserve the best interests of the family, the incumbent generation not only transfers ownership of the firm to the next generation, but also ensures that the family will continue to flourish. However, conflicts of interest among family members may jeopardize this goal because they may compete for the family estate during the succession process (Grote, 2003). To avoid this, the incumbent generation needs to consider a succession plan (Sharma, Chrisman, & Chua, 2003) and allocate the family estate among members of the succeeding generation. This may ease the conflicts among family members and preserve family trust. Although the idea sounds desirable, the related plan and execution can be difficult.

In the search for a workable plan, diversification may be a practical measure for the incumbent generation to facilitate the process of inter-generational succession. Specifically, diversification may foster subsidiaries that are self-sustaining and independent. Once a succession process has been initiated, subsidiaries can become spin-offs and be assigned to the members of the next generation. In this way, the spun-off subsidiary will still be associated with the parent firm through partial ownership, but its operations and control rights will be independent. This would help resolve inter-generational family feuds over succession, expand family influence in the social network, and cultivate new resources for the family in other markets. Hence, the first hypothesis of this study suggests:

**H1.** For firms in emerging economies, controlling family ownership promotes the extent of corporate diversification.

### *2.3. Controlling family and diversification performance*

From an agency perspective, the "altruism" of the controlling family may have both positive and negative effects on firm performance (Chrisman et al., 2005). On the one hand, altruism may drive the controlling family to be more attentive to firm value, facilitate trust, communication, cooperation, and reciprocity in management, and foster loyalty and commitment of the controlling family to the firm and to its prosperity (Lubatkin, Ling, & Schulze, 2007). On the other hand, altruism may motivate the controlling family to entrench its corporate control from outsiders (Morck, Shleifer, & Vishny, 1988).

Drawing on the agency theory and the arguments of the altruism literature, controlling family ownership may have a contradictory impact on corporate performance and diversification performance. Specifically, the ownership concentration significantly aligns private interests of the controlling family with firm value that promotes the overall corporate performance (Jensen & Meckling, 1976). However, as suggested above, a firm's diversification in emerging economies would be motivated by altruism of the controlling family to preserve its controlling right for the future generations, making diversification part of controlling family entrenchment. Once diversification has been used to facilitate inter-generational succession, the controlling family may favor diversification in markets that are unrelated to the core business of the firm as this would minimize the possibility of family members competing against each other in the same market. Consequently, the controlling family tends to override the optimal scope of firms to pursue a wider range of diversification, despite that the decision may destroy firm value (Hoskisson et al., 1993; Tallman & Li, 1996). Hence, the second hypothesis of this study suggests:

**H2.** For firms in emerging economies, controlling family ownership negatively moderates the performance of diversification strategy.

### *2.4. Bank as a stockholder and diversification decision*

Evidences from studies in both developed and developing countries reveal that the presence of institutional investors promotes good corporate governance (Young, Peng, Ahlstrom, & Bruton, 2002). However, research also shows that the strategic preferences of institutional investors differ due to their objectives and their levels of resource commitment (Le, Walters, & Kroll, 2006). Specifically, institutional investors such as mutual funds aiming at maximizing returns usually emphasize the efficiency of the investment (such as low costs and short time) and thus are reluctant to participate in governance activities. In contrast, other institutional investors like banks usually have long-term relationships with the firms they invest, and thus would be more willing to participate in the corporate governance to protect their investment.

As argued above, for firms in emerging economies, diversification can be associated with the entrenchment of the controlling family aiming to facilitate its succession plan. However, a succession plan aimed at keeping the controlling family in control tends to contradict the interests of other shareholders (Filatotchev & Toms, 2006). In the event that a bank holds a significant proportion of shares of the firm, the bank would be active in corporate governance, and this would limit the entrenchment of the controlling family on the firm's diversification decision. Hence, the third hypothesis of this paper suggests:

**H3.** For firms in emerging economies, bank ownership has a negative effect on the decision to pursue diversification.

### *2.5. Bank as a stockholder and diversification performance*

Within the relation-based networks of emerging economies (Li, 2009), banks play a critical role as the structural link between the holders of surplus capital and those in need of financial resources (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997). From the institutional perspective, a lot of unmet needs exist in emerging economies due to the immature institutions (Peng & Delios, 2006). Dependent upon the specific network position of the bank, the invested firm would be able to find various opportunities and then take advantage by entering the markets through a diversification strategy.

In addition, most of the banks in emerging economies are affiliated with local governments (Claessens & Fan, 2002), and this affiliation could be advantageous in supporting the diversification strategy of their invested firms. For example, according to the statistics of the Central Bank of Taiwan (Annual Review of Domestic Banks 2003), of the five largest domestic banks in Taiwan, three are wholly state-owned and two are partially state-owned and fully state-controlled. As a result, the investments of banks in the firms would effectively connect the operations of these companies with state interests that may foster their diversification performances (Yiu, Lu, Bruton, & Hoskisson,