

ÇANKAYA UNIVERSITY
GRADUATE SCHOOL OF SOCIAL SCIENCES
INTERNATIONAL TRADE AND FINANCE

MASTER THESIS

CORPORATE DIVERSIFICATION AND FIRM PERFORMANCE

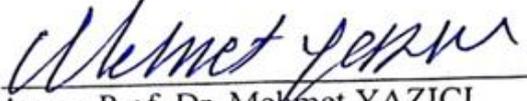
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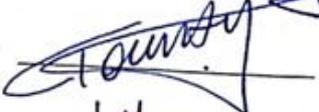
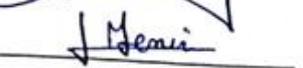
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ABSTRACT

CORPORATE DIVERSIFICATION AND FIRM PERFORMANCE

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The aim of this research thesis is to examine the effect of corporate diversification which remains to be one of the essential strategic options that a corporation may execute to sustain growth and profitability, on firm performance by using random effect panel estimation. For this purpose, the determination of diversified firms is based on group affiliation which is a widely used proxy for corporate diversification in emerging economies. The research covers the period of 2001-2010 and concentrates on the Turkish listed manufacturing companies. The findings suggest that there is no statistically significant effect of group affiliation on firm performance as measured by stock returns.

Keywords: Corporate Diversification, Business Groups, Firm Performance, Emerging Economies, Panel Data

ÖZET

KURUMSAL ÇEŞİTLİLİK VE FİRMA PERFORMANSI

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Danışman: Dr. Ece C. KARADAĞLI

Şubat, 28 Sayfa 65

Bu araştırma tezinin amacı, rastgele etki panel değerlendirmesi kullanarak, bir şirketin büyüme ve karlılığı sürdürmek için uygulayabileceği temel stratejik seçeneklerden biri olan kurumsal çeşitliliğin, firma performansı üzerindeki etkilerini incelemektir. Bu nedenle, değişik firmaların belirlenmesi, yükselen ekonomilerde kurumsal çeşitlilik için çokça kullanılan bir temsilci olan grup bağlılığına dayanır. Araştırma 2001-2010 dönemini kapsamakta olup, Türkçe listelenen imalat şirketleri üzerinde yoğunlaşır. Bulgular, hisse senedi getirisi ile yapılan ölçümlere göre, grup bağlılığının, firma performansı üzerinde istatistiksel olarak önemli bir etkiye sahip olmadığını gösteriyor.

Anahtar kelimeler: Kurumsal çeşitlilik, iş grupları, firma performansı, yükselen ekonomiler, panel verileri

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INTRODUCTION

The term "diversification" is generally related to the change in the characteristic of the company's market or production lines through market development, market penetration and product development. Through referring to the process of operating in different product markets and industries, corporate diversification proves to be one of the essential strategic options that the corporation may execute to sustain growth and profitability.

The strategic option of diversification has been adopted at the early 1950's when the firms started to diversify the risk associated with the investments. This strategy continued to attract the managers and became more acceptable in the 1960's, and later in 1970's the trend was to establish conglomerates by adding new unrelated business lines and products. This operation continued till the 1980's, when the doubts of the positive effect of corporate diversification started to be shown, and managers started to be more interested in concentrating on their core businesses. (Robert M. Grant 2008)

The concentrated strategy continued during the 1990's when the managers focused on the maximization of the shareholder value which require more transparency that is easier to reach with less number of business lines. Later in the recent years of the twenty- first century the advanced technology played a critical role in the formation and of the organization and has made the structure of the firm more sophisticated.

Firms may achieve corporate diversification either by using their internal sources to grow and extend their activities or by using external sources through acquisitions, mergers and establishing business groups.

The two generic types of diversification are the related diversification and the unrelated diversification. The related diversification which can be performed through

Forward integration and backward integration is an attractive corporate strategy as it offers diversification and keeps the businesses close in term of relatedness.

The second type of corporate diversification is the unrelated diversification (or the conglomerate diversification, or pure diversification) which refers to the strategy of expanding the firm's activities into completely new markets and products that are unrelated to its core activities.

The main motivations for managers to diversify a firm, as Montgomery (1994) cited, are related with;

- The agency theory: this theory seeks to explain the relationship between two or more parties; one is the agent of the other called the principle. The basic observation of the agency theory is the asymmetric distribution of the information between the parties, which may led to the opportunistic behavior of the management.
- The resource-based perspective: this is also referred as the synergy view and concentrates on the gains that come from cost advantages.
- The market power: it refers to the anti-competitive strategies adopted to increase profits in the diversified firms, which have the advantage of having access to the conglomerate power.

There is a wide argument in the strategic management and finance literature regarding the role played by corporate diversification as a strategy of value maximization for shareholders. Accordingly, the finance and the industrial organization literature have investigated a vast array of research concerning the important relationship between corporate diversification (business group) and firm performance. However, within the content of this relationship an important distinction arises depending on whether the firms mainly operate in a developed or developing country.

The categorization of countries into developed, emerging and third world countries has been adopted to determine the development degree of countries and is based on many factors such as GDP, the per capita income, the infrastructure, and many other factors. For instance countries such as U.S.A, U.K, Germany and all other countries

that have high industrialization, high GDP and high human development level in terms of such factors as literacy and health care system, may be classified as developed countries. On the other hand, countries that have institutional voids and experiencing a good growth rate and industrial prosperity may be classified as emerging countries such as Turkey, China, India, Chile, Indonesia, etc. (Khanna and Palepu 2000) and in emerging countries, business groups are widely accepted to be the path towards corporate diversification. Diversified business groups are widely obvious and dominant in emerging economies such as Turkey, China, India, Mexico, Chile, Pakistan, South Korea and Indonesia. They control the economies of these emerging markets by playing an important and controversial role.

Theoretical arguments mostly cited corporate diversification as a value-enhancing strategy for firms. For example, Fluck and Lynch (1999) argued that corporate diversification allows the financing of marginally profitable business that is not easy to be financed as a single unit and Matsusaka (2001) argued that firms may choose to go through diversification when the gains resulted from seeking for a better organizational fit overcome and cope the cost of reduced specialization. Generally, firms choose to diversify when the potential benefits of diversification cope its costs, and firms stay concentrated when the opposite happens.

However, the empirical evidence obtained for developed economies in the corporate finance literature, mostly suggested that diversified firms trade at a discount comparing with single-segment firms, which have led the researchers to think that diversification may reduce firm value (Burger and Ofek 1995, Lang and Stulz 1994, Servas and Zingales 2000, and many others). This indicates that, generally, firms cannot encounter the potential benefits of corporate diversification by controlling the related costs (Lins and Servaes 1999). Hence, it may be argued that in developed economies the costs of diversification outweigh the benefits. However, because market imperfections are more intense in developing markets, the relative benefits and costs are not necessarily the same size (Lins and Servaes 2002).

There are several reasons that posit operating under a group affiliation will provide various benefits to the related group firms in a developing market context (Khanna and Palepu 2000a). Khanna and Rivkin (2001) argue that the external markets are

typically observed to be underdeveloped in developing economies which creates a considerable place for diversified corporate structures to create value. Accordingly, in developed economies, as a result of the institutions that reduce the sources of market failure and imperfections, firms can create value by concentrating on a relatively narrower range of activities while in the developing economies because of the market imperfections caused by the institutional voids, firms usually need to perform some of the basic functions by themselves (Khanna and Palepu 1997). As also argued by Khanna and Rivkin (2001), group firms have a critical role in overcoming the market imperfections that may arise from the institutional voids of the emerging economies. The scale and scope of groups enable business groups to create greater value relative to more concentrated, unaffiliated firms (single), through imitating the market institutions (Khanna and Palepu 1997; 1999a; 2000a). though highly affiliated business groups are found to be well suited to the institutional context particularly in emerging countries. Besides, in developing markets the observed market imperfections which are also reinforced by asymmetric information and agency problems, group firms will benefit more from the efficiency enhancing functions relative to the firms operating in developed markets. Therefore, in emerging markets it can be expected that the benefits of corporate diversification will outweigh the related costs and it can be assumed that in emerging markets the effects of corporate diversification would be value enhancing or at worst less value deteriorating.

However, the empirical evidence for emerging economies provides contradictory results (Raymond J. Fisman and Tarun Khanna 1998, Krishna Palepu and TarunKhanna1998). As the findings are still not conclusive, there is still an open door to investigate the effect of the strategy of corporate diversification.

Following the aforementioned arguments, this research thesis attempts to investigate the effect business group affiliation which is a widely used proxy for corporate diversification in emerging markets, on firm performance in an emerging market, Turkey, by using random effect panel estimation. The research covers the period 2001-2010 and the sample consist 134 Turkish listed manufacturing companies among which 79 are affiliated business group firms and 55 are unaffiliated individual

firms. The findings suggest that there is no statistically significant effect of group affiliation on firm performance as measured by stock returns.

The remaining of this study is organized as follows: In the second section, corporate diversification is explained in detail. In third chapter, the valuation effects of corporate diversification are discussed and past empirical research is reviewed. In section four, data and methodology is discussed and analysis results are provided. Finally, chapter five concludes.

CHAPTER I

CORPORATE DIVERSIFICATION

1.1 DIVERSIFICATION CONCEPT.

The concept of Diversification is closely related with the concept of risk. Successful firms are looking for transferring their good and profitable business experience to totally new activities to reduce the risk through diversification. For these corporations diversification means looking for new markets or industries as good opportunities for profit and growth, or in the case of the firm that have been successful but facing less profitable market or bad times, are seeking in a way or another to regain back its glory days through taking new business, therefore diversification for these firms is like survival and vital to keep the position of these firms on the top.

Diversification is about taking the risk and venturing the firm into the unknown to achieve higher profit and greater competitive advantage. The decision of diversification into new business is a strategic decision taken at the highest level that affect the fundamental direction of the firm, taking such a decision of diversification has sometimes considered as a high risk toward the unknown. While some firms succeed, many others lose or go through financial problems such as bankruptcy.

Nonetheless, when it comes to the attraction of the growth and the new opportunities that could be gained from the diversification into new business, diversification still appears to be an irresistible idea for most companies. This can be clearly observed for the majority of the big diversified companies like Nokia, Philips, General Motors, Samsung and Microsoft which are all examples of diversified companies (conglomerates) as a mean of seeking for a constant way of profitable growth and position.

Furthermore diversification is not peculiar for the big companies; rather, it can be used by small business and entrepreneurs who face the same challenges of growth, profit as well as risk problems.

Diversification can be defined differently by different disciplines. For example, in economics, diversification means finding new and more diverse array of sources of wealth, GDP growth, export revenues and labor possibilities.

Within the scope of portfolio investment, it refers to the practice of holding a portfolio composed of different investments that will yield higher returns while posing lower risk. As many researches and models in investment management have shown, a well-diversified portfolio of a chosen stock will yield benefits of diversification if the chosen investments are less than perfectly positively correlated. Meanwhile in the content of managerial strategy “diversification” is a strategy of business development allowing the company to enter additional lines of business that are not correlated with the firm's activities.

Within the scope of this research thesis, following the definition of strategic management, diversification can be defined as the process of operating in different products, markets and industries, which is usually referred as corporate diversification.

1.2 BACKGROUND & HISTORY

The idea of the diversification strategy is not newly adopted in the financial management fields. The depression of the 1920's forced organization into diversification especially electrical manufacturers and chemical companies such as Westinghouse and General Electric according to research by Chandler (1969). The concentrated strategy tended to increase during the World War II and declined slightly thereafter. World War II encouraged organization to adopt diversification by open new opportunities for the production of totally new products such as war equipments and radars.

Later, in 1950s (post-war) era when it became a popular strategy to let the corporations diversify over different markets and lines keeping up with the saying that: “Don’t put all your eggs in one basket”. The post World War II era characterized by constrained demand and the rapid expansion of government spending on research and development (R&D) which give momentum to diversification.

This strategy continued to attract more and more managers till the 1970s when the time was suitable to establish conglomerates through extending the area of business by adding more unrelated businesses to the corporation till the 1980s, when the trend of diversification went down and became a less adopted strategy comparing with the strategy of focusing on core competences which was a reflection of financial economists and business leaders when they started to question the value of diversification [1]. And the reason was the increased concentration on shareholder value which requires transparency that is hard to achieve in a company with multiple businesses.

Later in the beginning of the twenty-first century corporate strategies has continued to change and became more sophisticated due to the huge technological evolution. Today corporate diversification strategy still exists as a strategy (even as its glory days seem to be in the past) and will continue to exist as long as it attains the essential motivations of the corporation: growth, profitability and risk reduction. [2]

1.3 THE TWO SOURCES OF DIVERSIFICATION.

Firms can diversify into new product markets and industries by using its internal sources through investing their own resources and expanding their own businesses into new markets and/or by the use of external sources that is, through mergers, acquisitions, joint ventures, becoming holding companies and establishing group firms.

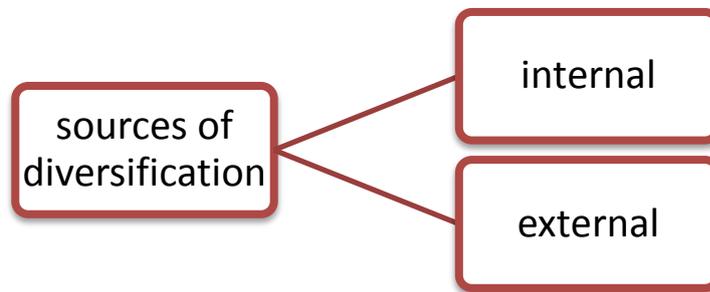


Figure 1. The Sources of Diversification

1.4 THE TYPES OF DIVERSIFICATION STRATEGY.

There is no standard typical strategy that may be applied by all corporations and firms for diversification. Rather, as firms are different from each other in various aspects such as their size, activities, scale, geographical location, capital, manager's preferences, ownership structure etc., there are many ways that they can achieve corporate diversification as well.

When a firm decides not to engage in corporate diversification by concentrating on a single production line or focusing on a single business line, it means that this firm is following the concentration strategy and the enterprise is concentrated to do the same thing in the same way, in another words, the enterprise is specialized in only one type of business. Concentration strategies are also known as intensification, focus or specialization strategies.

Peter and Waterman (1982), in their " In Search for Excellence" advocated a parameter for successful firm which called as a "stick to the knitting" [3]. A good firm always depends on focusing on doing what they are best in doing.

Now we can see from the classic Ansoff's products-market matrix which was proposed in a 1957 article in the Harvard Business Review and is still used by strategic planners and managers as a growth strategies:

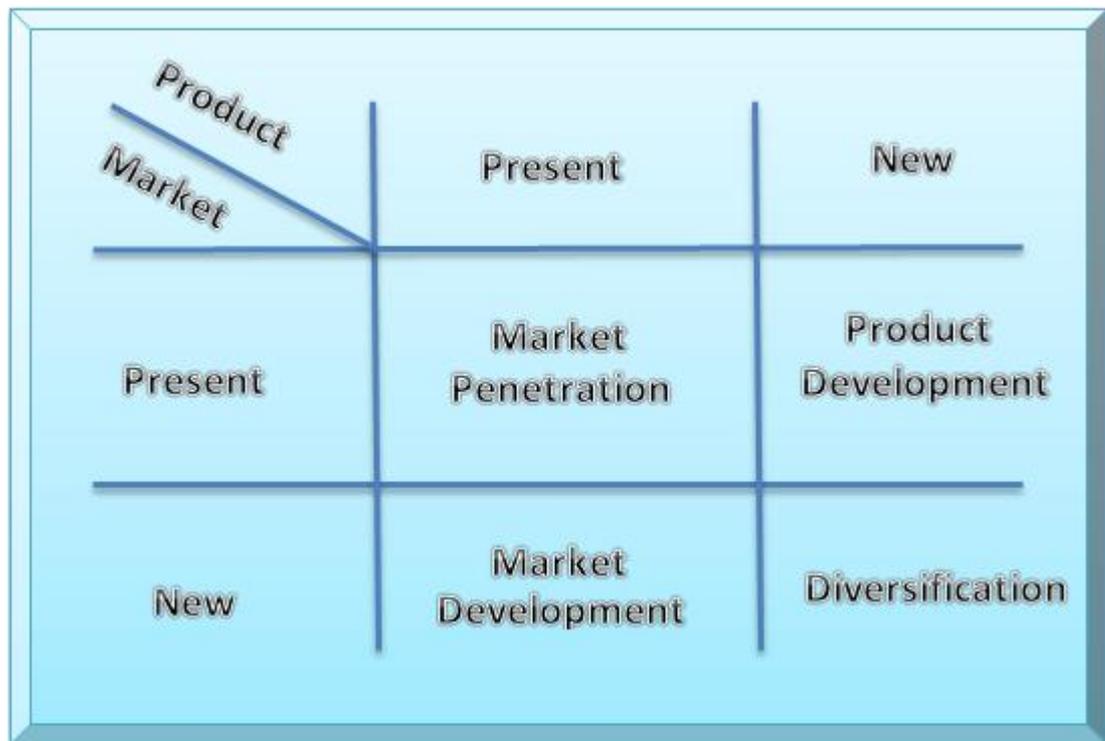


Figure 2: Ansoff's products-market matrix.

From the matrix we can summarize or conclude three types of concentration strategies: [4]

1) Market Penetration:

It means increasing the selling quantity of the product in the same market. This strategy intends to reach four main objectives,

- Maintain or increase the market share of current product
- Restructuring the market by pushing out the competitors.
- Increase the usage (consumption) by the costumers.
- Dominance of growth market.

2) Market development:

It means the strategy of attracting new customers for existing products by selling the same products to new markets which are not necessarily be in the same geographical

area, since we can sell in the same area but for new customers based on different criteria as well as demographical criteria.

3) Product development:

It means the strategy of selling new products to the same markets. In another word, by developing the product or producing a completely new products to the same market.

4) Diversification:

Is the most risky between the four strategies since it requires both market and product development which may be unrelated to the core competencies of the company.

From all above we can conclude that the concentration strategy has many advantages and strength points because starting of the business with this strategy means that the business is more manageable and controllable, and the company can develop its market, its technology, its customers and the organization as a whole.

Concentration strategy is among the top priorities of the firm because the firm would like doing more of what it is doing now. Besides, concentration strategies can set many potential for the organization to:

- Become proficient at doing one thing very well.
- Have a good reputation by its identification with particular technology-customer-product application combination.
- Use its accumulated experience and expertise to gain sustainable competitive edge.
- Managers face less problem dealing with known situation.

Furthermore, when firm's managers decide to quit doing the same activities and start to follow the strategy of diversification, they have two generic types of corporate diversification to choose among: [5]

- 1- The strategy of related diversification.
- 2- The strategy of unrelated diversification.

1.4.1 The Strategy of Related Diversification.

Related diversification strategy is an attractive corporate strategy as it offers diversification of the organization from its original business as well as keeps it close to it in term of relatedness. [5]

Using this strategy may take us to the way of making good profits since it is all about extending the firm expertise to close businesses. This type of diversification is used mostly by small businesses because it is less risky than the other type of diversification.

In the majority of the cases, it does not require big investment and owners feel more secure because they know the opportunities and threats that they may face in the field of their main business activities.

For further illustration for related diversification, we can look to a bread bakery that starts to produce crackers, or a sugar factory that starts to produce paper and wine from its wastage in which previously they used to throw it, or as a well-known coffee company that starts to produce tea using its competitive advantage of the brand name of the coffee.

Related diversification can also be achieved through the vertical integration, which refers to a situation that an organization starts producing new products to serve its own needs. Vertical integration can be viewed in two forms: Backward Integration or Forward Integration.

The backward integration means retreating to the source of raw material. Thus, a firm which decides to make more of its own parts rather than purchasing them from outside engages in backward integration. It stays in the same industry line but changes its production range through extending into the raw material stages.

Forward integration moves the organization ahead taking it closer to the customer, for example when a firm starts to open a chain of retail stores to deliver the products directly to the customers.

Sometimes when a manufacturer decides to integrate backward to the raw material stages, he may convert the cost to profit. Meanwhile backward integration avoids the firm to be dependent on suppliers. Backward integration further provides other advantages like minimizing the risk of losing the information to the outsiders etc.

The same points may be observed in the forward integration as well. Additionally, forward integration may provide an efficient tool to manage undependable sales and distribution channels through building company-owned and operated sales centers. At the same time these strategies may have some disadvantages such as the large capital used by the firm to accomplish a full integration. Besides, managerial difficulties may also arise due to extending the business activities: Managers may need to learn new managerial skills when they start to manage a larger organization.

1.4.2 Strategy of Unrelated Diversification.

Unrelated diversification or conglomerate diversification refers to the strategy of expanding the firm's activities into new markets and products far away from its core activities. Sometimes the unrelated strategy is also called as "pure diversification" when there is no relation or mutual element between organization's activities or operations. This strategy is based on the concept of any new business or company that can be acquired under favorable financial conditions and has the possibility for high revenues.

Some organizations are considering unrelated diversification strategy as the only way for them to escape from a declining industry or from the one line production that is no longer attractive in the market or no longer profitable. Or sometimes unrelated diversification may reflect a managerial decision for company with capital surplus but no opportunity in the markets to acquire a capital deficit company with too many opportunities. In other words, it may arise from a situation in which a cash-rich, opportunity-poor company seeks for a cash-poor but opportunity-rich company. Another motivation may arise due to a situation in which a company involved deeply in debts seeks for a debt-free company to make capital balance.

Furthermore, another important motivation to engage in unrelated diversification is to spread the risk associated with investment decisions.

On the other hand, this strategy encompasses managerial problems mostly rooted in the difficulties of managing a widely diversified business which may require high and special skills to deal with it and may lead to a high managerial cost.

For further explanation of these possible problems, some examples are illustrated below:

- 1- Within the economic fluctuation in the world "whenever firms managers decide to diversify into new business, they should ask the question 'if the new business went down would we know how to bail it out?' If the answer is NO, it is likely representing the wrong kind of diversification." [6].
- 2- The high profits and sales that have been achieved by the diversification strategy, may not survive against a small stress or economical recession [7].
- 3- When the diversified portfolio is not strategically suitable or fit and the performance is not unified, the returns and revenues of this portfolio may not be better than the sum of what the individual business could achieve which may lead the management to make a strategic decision about what business should we get rid of and which one should we add to the portfolio to make it profitable again. [8]

From the generic types of corporate diversification strategy, we can see that the most accepted and adopted one is the unrelated diversification or conglomerate in the all times since the rise of diversification thought, and that is clear as we mentioned before that many scholars called conglomerate as "the pure diversification or the real diversification".

1.5 THE REASON FOR DIVERSIFICATION.

Montgomery (1994) defines three basic theoretical perspectives that may be considered as motives or reasons for the firms to go through diversification: [9]

1.5.1 Agency Theory

1.5.2 The Resource Based View

1.5.3 Market Power

1.5.1 Agency Theory.

This theory seeks to explain the relationship between two or more parties in which one of these parties acts as the agent of the other party, called the 'principal'.

The agent undertakes to do specific tasks for the principal, and the principal undertake to reward the agent. Through the concept of agency theory it can be envisioned that diversification maybe resulting from the behavior of managerial self-interest at the expense of the stockholders, or in other words, firms' managers' act as agent on behalf of the shareholders, and this relationship is most probably fraught with opportunistic behavior of the management, which may lead to complicated conflict. That is, managers may follow strategies that may not come up with the shareholders' interests.

The main observation underlying the agency theory concept is that information is distributed asymmetrically between the parties of the agency relationship. To be more specific, shareholders usually cannot judge the value of an executed strategy sufficiently; neither can they control the efforts of managers completely. Another point of critical importance refers to the separation of control and ownership within modern corporations. Because of diversification investors' equity shares are widely scattered and as a result no single equity owner has the possibility to enforce value maximization. Though investors may perform a certain degree of control, compensation contracts may switch the managerial behavior towards value maximization through bonus systems, profit sharing or managerial holdings. [10]

After pointing the problem of this concept we may suppose the following reasons for the managers to undertake diversifications;

- Increase their compensations, power and prestige.

- Try to secure their position in the organization (immunize themselves) by going through investments that require their specific skills via manager-specific investment.
- Minimize the potential risk of their personal investment portfolio by reducing the risk of the firm as a whole.

1.5.2 The Resource-Based Perspective. (The Synergy View)

The term synergy in economic literature refers to the efficiency gains that come from cost advantages.

By analyzing a firm with multiline products, potential cost advantages result from joint production facilities. Cost-saving results when a company or a unit transfers its expertise in one business to a new business, these businesses may share raw material and equipment or other existing assets like expertise, patent and competencies. Even more businesses may share operational skills and know-how in the production operation to achieve this cost-saving concept.

For instance, the firm may use the same marketing and distribution channel to market a combination of commodities and services. The same goes, when the firm may be able to use its corporate financial and legal staff in the best way to support a collection of different businesses and activities.

This cost functions which can be referred as "economies of scope" mostly results from related diversification and due to this it may be called as "economies of diversification".

1.5.3 The Market Power.

It refers to the possible anti-competitive strategies followed to increase profits in the diversified firm, whereby the firm's management behave in the best way for achieve the interest of shareholder "The concept of the market power view is that diversified firm will prosper at the expense of single firms not because they are not efficient, but

because they have access to what is termed "conglomerate power" which is derived from the sum of its market power in individual market". [11]

For this theoretical perspective and to understand the motivation for diversification strategy, Villalonga (2000) introduce three different motives for diversification: [12]

- The firm uses the profit resulted by the organization in one industry to support the predatory pricing in another.
- The second motive includes conniving with other companies that simultaneously compete with the company in the same market.
- The third motive for the firms may be the using of corporate diversification to push out other small competitors through engaging in mutual buying with other big firms.

Furthermore, Hill and Jones (1998) suggest other reasons for diversifications when firms generate financial resources in excess of the founding required to maintain a competitive advantage in their core business. They suggest that a diversified firm can create value in three ways:

- **Acquiring and restructuring:**
The core of the acquisition is to purchase a company that is poorly managed and increase the efficiencies through the expertise of acquirer's management. The acquirer does not have to be in the same industry as the acquired company in this approach.
- **Transferring Competencies:**
This approach is achieved by the firm transferring key competencies in one of their value creation functions such as marketing and manufacturing to improve the competitive advantage of the new business lines.
- **Realizing economies of scope:**
When two or more business firms share resources such as advertising, research & development and expertise.

Furthermore, Haberberg and Rieple (2001) posit six reasons as why the organizations might go through diversification. These reasons are:

- **Seek growth and capture value added opportunities:**
Corporations may realize opportunities for growth that are hard to find in their core businesses through diversifying into new businesses. This action may lead them to achieve profits and value for the organization.
- **Spread Risk:**
Corporations may chose diversification to spread risk through diversifying into different business, this action is known as hedge.
- **Prevent Competitors from Gaining Ground:**
Organizations may diversify into new business to prevent the competitors from gaining ground in specific product or market. This approach may be viewed as a defensive action by the managers.
- **Achieve Synergy:** in achieving synergy, the firm is seeking for coordinating some functions by sharing the value chain. Activities such as productions and purchasing among business units could lead to economies of scope and scale.
- **Control the Supply and Distribution Channel:** firms may diversify to gain control either by forward or backward integration which may influence the prices and the supply of raw materials to the whole organization.
- **The Fulfillment of Personal Ambition by Senior Management:** some organization may reward their managers for the size of the firm rather than the financial performance; this may lead the managers to seeking diversification in order to increase the size of the firm.

Hitt, Ireland and Hoskisson (1999) have cited that there are internal and external incentives for companies to follow diversification strategy. The below table summarizes the external and the internal incentives of diversification.

Table 1 External and internal incentive for diversification.

External incentives	Internal incentives
<p>Antitrust regulations: Regulation either inhibiting or promoting diversifications plays a role. The regulations may encourage either diversification in unrelated business due to the strict regulation to encourage competition and therefore avoid monopolization, or the regulation is more conducive to mergers acquisitions within the same industries.</p>	<p>Low performance: Companies that have had poor performance over a long period of time may be willing to take greater risks in attempt to improve performance thereby diversifying into totally new businesses.</p>
<p>Tax Laws: Tax laws may encourage companies to rather reinvest funds as opposed to distribute the funds to shareholders. Higher personal taxes encourage shareholder to want the companies to retain the dividends and use the cash to acquire new business as opposed to distribution to shareholders.</p>	<p>Uncertain future cash flows: Firms operating in mature business and industries may find in diversification a defensive strategy to survive over the long term.</p>
	<p>Risk reduction: Firms that have synergies between business units may face greater risk as the interdependencies between the business units increase the risk of corporate failure. Corporate diversification may reduce the interdependency and reduce the risk</p>

Hitt, Ireland and Hoskisson (1999).

1.6 STRATEGY TO MANAGE DIVERSIFICATION

1.6.1 Corporate Turnaround And Retrenchment Strategies.

Turnaround: means substantial and sustainable positive changes in the performance of the unit through determined efforts [13].

Turnaround strategy is one of the increasing cases in the business world, since it has a direct relation with the phenomenon of business failure and problems. Thus many scholars and academics describes turnaround as a sustainable recovery of sick units taking them to their normal situation, or as a positive change in the unit's performance from losing to gaining, from inactive to active units, etc.

The mechanism of the turnaround strategy generally is about aiming to take back the losing units to the profitability, redesigning the portfolio by replacing the bad business with more attractive business, and in some cases of turnaround the changes is about the managerial levels, when they may be the reason for this weakness points in the diversified portfolio (managerial gaps).When this gaps may happen because of the decisions of over-diversification or over-expansion.

Corporation retrenchment: is defined as a strategic option that involves reduction of any existing product or service line along with the level of objectives set below the past achievement [14]. Corporate Retrenchment can be viewed as a reaction for the uncertainty about the future, and financial crises or / and recession. This defensive reaction may include many procedures like increasing the profit margins, productivity, and even some times decreasing the organization staff, closing the unprofitable product lines. Or it may be such a radical actions for the sick units by isolate this product lines and delaying the expansion plans. From the above we can look to the corporate retrenchment as a short-run strategy for the companies in their bad times.

1.6.2 Abandonment, Divestiture, and Liquidation Strategies.

Even a highly organized diversified organization, with carefully selected businesses, may face a bad situation sometimes. Though managers of these organizations may not predict the exact result of these diversified businesses which they selected.

In addition to the fluctuations in the markets and economy, a partial misfit and unsatisfactory performing units may show up.

The option of getting rid of these sick units is called “Divestiture” or “Abandonment”.

When particular units start to lose its productivity and its appeal, divestiture may be the best solution for this case, and the option of divesting these units and take them out of the corporation's activities. Some corporation's managers set abandonment plan to face such a situation in advance. "A useful guide for determining if and when to divest a particular line of business is to ask the question ‘If we were not in this business today, would we want to get into it now ?’ if the answer is no or probably not then divestiture ought to become priority consideration.”[15]

Liquidation strategy; is the most hard and cruel strategy of them all since it involves shutting down the operations of business unit and selling it. This action may be harmful and painful for the company that runs a single business, because that means terminating the existing of this company, but starting the operation or the option of liquidation in earlier times, is often better than keeping this decision to later time, since selling these assets early is better than hard bankruptcy. The late liquidation may cause the assets to lose value which in turn means less to liquidate.

1.6.3 Combination Strategies.

Combination strategies are a mixture of expansion, stability or retrenchment strategies, applied either sequentially (at different times in the same business) or simultaneously (at the same time in different business). [16]

It is quite hard for a company to adopt single strategy all the time. Because even a company that has adopted a stability strategy, someday may think about expansion or acquisition in order to keep up with the market competition and growth requirement, or a corporation which has been in expansion strategy for a long time, needs to stop for a while and take breath to rearrange its businesses and operations.

Finally we can summaries the alternative strategies for the corporation including diversification's options in table 2.

Table 2: diversification strategies.

The Strategy	Definition
Forward integration	Increasing ownership and gaining control over retailers and distributors.
Backward integration	Looking for ownership or increased control of suppliers
Horizontal integration	Increasing control and ownership over competitors
Market penetrations	Increasing market share for recent service or product in the same market through marketing.
Market development	Seeking for new geographical areas for the same products and services.
Product development	Improving the products and the services to increase the sales.
Related diversification	Adding new products and services but related to the core activities.
Unrelated diversification (conglomerate)	Adding totally new and unrelated businesses.
Joint venture	two or more parties agree to pool their resources and efforts for the purpose of accomplishing a specific business.

CHAPTER II

THE EFFECT OF CORPORATE DIVERSIFICATION ON THE FIRM VALUE

The decision of running a firm with a variety of businesses or concentrating on the core activities has been considered as a vital strategic decision in the corporation management. The argument of whether corporate diversification enhances or destroys the firm value have been studied and discussed for the last five decades, and too many articles and researches in this topic have provided contradictory results.

2.1 CORPORATE DIVERSIFICATION AND THE FIRM VALUE: THEORITICAL ARGUMENT.

Many of recent papers and researches attempt to find the answer to the question "does corporate diversification destroy the firm value or enhance it? ".

Several scholars and researchers try to find a distinct answer by comparing the market value of a diversified firm to the value of single firms operating in the same industries as the conglomerate divisions.

For instance one of the most important studies in this field is provided by Lung and Stulz (1994) who used this comparison and have found that diversified firms have lower value of Tobin's q compared to single firms.

Similarly, Philip G.Berger and Eli Ofek in their article "Diversification effect on firm value 1995" find that the American conglomerates are priced at a discount of about 15%.

The same discount has been found by Lins and Servase (1999) in the U.K. and Japan using the same methodology of Berger and Ofek. This phenomenon is termed as the diversification discount.

Most of these financial studies tend to use the Tobin's q as the value measurement of this discount. Tobin's q can be defined as the present value of future cash flows divided by the replacement cost of tangible assets. [17]

Tobin's q may indicate the value of the firm's intangible assets, like investment opportunities, brand name, and reputational capital, etc.

Lang and Stulz (1994) used Tobin's q in measuring diversification effect in financial literature to indicate the relationship between the degree of the firm's diversification and the market value. Lang and Stulz conclude their study with the result that the widely diversified firms have lower average and middle Q ratio than single-segment firms, and they support the view that diversification is not the best path to higher performance.

Many theoretical arguments suggested that corporate diversification has both value-reducing and value-enhancing effects. [18]

The potential cost of diversification may result from undertaking value-deteriorating investments, or from the mismatch of motivations between central and divisional managers, and cross-subsidies that allow the weak sectors to waste the resource from the good-performing units.

Because it is possible for the firm to assign too many internal resources to poor-performing units, which will cause the inefficient use of internal resource in the diversified firms.

Meanwhile, the potential benefit of operating in diversified businesses by one firm may contain greater operating efficiency, bigger debt capacity, less stimulant to forego positive value projects, and lower taxes.

Furthermore, many different explanations of the diversification cost have been argued based on the above notices. The negative influence from the diversification

generally focused to the high management cost, cross-subsidization to unprofitable units and the asymmetry of information.

Following the same method of Berger and Ofek (1995), Shin and Stulz (1998) found the same evidence about the value loss from the internal capital. Because of the strong incentive of the managers to maintain their position in the poorly performing units.

Serveas and Zingles (2000) posit similar view that the relative value of the division will not determine the allocation of resources, and the facility of tunneling capital resources within the internal capital market will maximize the agency cost.

They also argued that the more the resources among segments are diversified, the more difficult is the resource allocation. Whether based on the value, or based the performance of the segment and as a result the chance for poor performance segment to pull the resources will be bigger in the diversified environment.

After all a critical question may arise, why a firm diversifies in developed countries? We should take to the account the advantages that the strategy of diversification may hold. In fact, managerial economies of scale may result the gains for this strategy as cited by Chandler (1977).

Furthermore, "the increase of the market power is determined by the future higher prices and predatory pricing, and sustained losses that can be founded through cross-subsidization whereby the firm taps additional revenues from one product to support another" (Tirole, 1995).

The conventional theory cited that "one of the positive effects of corporate diversification is the reduction of the firm's risk in the way to be involved in more businesses in its portfolio" (Sobel, 1984; Grant, 1998). The reduction of the risk is also helpful for cost of capital and debt capacity (Lewellen, 1971), "because it allows the firm to exploit the tax advantages available from increasing borrowing" (Sheifler and Vishny, 1992).

However, business groups enjoy wider flexibility in capital formation, because they can access in easy way the external sources and internally generated resources.

Furthermore the strategy of diversification itself creates internal capital markets that provide more efficient distribution of resources between units, in that case multi-segments corporation gain significant financial benefits from the use of this internal market and resources (Rumelt, 1982).

Williamson (1975) and Weston (1970) discussed that manager enjoying controlling and information advantages over other external capital markets. Because, diversified firms are likely to create efficiencies that are unattainable to the undiversified firm.

The coinsurance effect may give diversified firms greater debt capacity than single-line business of similar size (Lewellen, 1971). Increased debt capacity may create value through increasing interest tax shield. Therefore diversified companies are expected to have lower tax payment and higher leverage than single companies.

Finally table 3 shows some examples for the contradictory result for studies on the relationship between diversification and organizational performance.

Table 3. Studies on the diversifications and firm performance.

The study	The result
Bettis 1981 Baysinger and Hoskisson 1989. Christensen and Montgomery 1981. Lubatkin and Rogers 1989. Palepu 1985 Rumelt 1974, 1982.	Argued the negative effect of corporate diversification.
Lubatkin 1987 Michel and Shaked 1984. Weston and Mansinghka 1971.	Came up with result that diversification is a value enhancing strategy.
Grant, Jammie and Thomas 1988. Montgomery 1985.	No relationship.

2.2 DEVELOPED ECONOMIES AND EMERGING ECONOMIES.

Terms such as "Developed countries, emerging countries and third world countries" are commonly used to categorize the degree of the country's stage of economic development. This categorization is based on many variables to evaluate the degree of the country development stage such as (GDP) the gross domestic products, the level of industrialization, the per capita income, well trained human resources, the high level of exports of a value added goods, the infrastructure of this country, the standard of living and the human development level (HDL) like education, health and literacy.

The designation of countries "developed" and "emerging" are purposed for statistical convenience and does not specifically refers to a judgment about the level achieved by specific country or area in the process of development.

In other words, this referring of developed and emerging countries is just for statistical purposes and does not have any presumption according to any political or other affiliation of territories or countries by the united nation ", [20] which defined the developed country through the former secretary general of the united nation Kofi Annan " A developed country is that country which allows all its citizens to enjoy a free and healthy life in a safe environment".

The term emerging market countries recently describe an economy with GDP or per capita income below the advanced world average in one hand, and in another hand with a growth potential above the global average.

From this the emerging countries may be seen as the countries or economies that are moving toward being advance. [21]

This progress needs too many procedures and reform actions to go through, because emerging markets may not have the high levels of market efficiency and accounting standards (not using the international accounting standards) and other strict financial regulation.

The emerging market economies (EME) may characterize as a transitional economies according to the international monetary fund (IMF), such as former

Soviet Union and Eastern Europe countries. because they are in the process of transition from closed market economy to open market economy through creating accountability relying on new financial reforms and policies similar to the ones that been followed by the developed countries as a standards and financial regulation.

This progress may attract the investors and investment companies to the emerging countries to participate in this transitional activities and what it may bring as opportunities for investments for the reasons below;

- Competitive labor market
- Surplus of resources
- Constructional maturations
- Economic rehabilitation
- Enhancing credit quality
- Rational debt ratios
- Potential for diversifications benefits.

These investments opportunities that we mentioned may come along with high risks since these transitional economies exist in areas where the political instability, currency volatility and weak infrastructure may play a big role in the unfavorable investments situations fluctuates and instability.

For the last two decades emerging countries have had growth rates over the world average. Furthermore, the recent financial crises (2008/2009) have emphasized the emerging countries as an economic powerhouse of the world according to the international monetary fund. [22]

This vital position as an economic powerhouse of the world and the prospered trade among emerging countries with the growing domestic consumption; gives the emerging countries a high self-confidence.

This self-confidence give them more effective and influential hand in the economic world, even more after the new and advanced governance and social reformations, these economies are eligible to enter the developed economies and playing this important role mentioned above.

For example the last financial crisis when China funded a large amount of United States budget deficit and for the rest affected countries, China and the other emerging countries act as a lender like the international money fund IMF.

Furthermore, the contrast between the emerging market economies and the developed economies in the recent years has become more blurred, and many emerging economies are today better than most of the developed economies when it compared in the terms of debt, budget indicators and other financial meters, which make it hard to distinguish the diversification effects on the firm performance, and even the political and live standards problems are no longer exist in many of these emerging economies.

2.3 THE EFFECT OF CORPORATE DIVERSIFICATION IN THE EMERGING MARKET.

The direct relationship between the firm performance and corporate diversification has been covered widely in the financial literature.

Generally these studies and researches suggested that corporate diversification should enhance the firm's performance in emerging markets.

For instance, in developed economies such as U.S.A, U.K., Germany, etc as an example for a developed market, the institutional context is mainly defined by well functioning capital, labor, and product markets. In contrast, in a developing market such as India, Turkey, Brazil and China, the problems of information asymmetry and agency theory are generally the resultant for a variety of market failures.

For example, the financial markets in emerging economies are characterized by inappropriate disclosure and lame governance and control for the corporations.

Intermediaries in all its forms such as mutual funds, venture capitalists, financial analysts and the financial press are not effectively involved in the market. In addition the regulations of securities are weak in general, and their effects are limited. The same problems are existing in the labor and product markets, all these are because of the absence of intermediaries. The absence and the inefficiency of these intermediary institutions makes the acquire of substantial inputs like technology, management skills and finance costly in emerging countries.

Also establishing a quality brand image in products markets is costly because of these market imperfections. and to find contractual relationships with joint venture partners.

In this case, a firm may be more positively performing its operations under a widely diversified business group, which may play the role of the intermediary between individual contractor and imperfect markets. As an example a well diversified business group is able to use their high reputation and track record in their new business lines to gain credibility and trustiness for new projects between customers and suppliers.

However and in this context According to the Transaction Cost Theory (Coase 1937, Williamson 1975) "the optimal structure of firm generally depending on the institutional context of the economy and the intermediary's efficiency in that economy".

Khanna and Palepu (2000) posit that the operations within a business group in emerging market is often beneficial, because as we mentioned earlier the external markets are characterized by institutional voids and spotted as underdeveloped.

Furthermore, the institutional context is also effecting in the economy, in another word, the effect of corporate diversification on the firm performance is also depending on the institutional context and structure of the economy. (Houston and Fanver 2001)

Accordingly in developed market and because of the existence of the institutions (intermediaries) that mitigate the market imperfection, firms are more incentive to create value through concentrating on less variety of activities, unlike the emerging market, firms are trying to joint ventures and acquisition to get through these market imperfections resulted from the institutional voids and the lack of intermediaries.

Considering the institutional voids in emerging market, Khanna and Rivkin (2001) posit that business group in emerging market can achieve important advantages through coordinating their activities by raising capital jointly, sharing a brand name and pooling resources in new ventures.

The most obvious feature of the business groups in emerging economies so far, is the ability of generating an internal capital market by it selves. [23]

The expensive external capital market in the emerging countries due to the sever market imperfections, makes the relying on the internal capital market more beneficial and attractive.

Beside in emerging markets, the information asymmetries problems are more serious and the unreliable financial reporting extending the gap between the investor and the

managers, which will increase the cost of external funds over the internal funds, leading to make the benefit of corporate diversification more clear.

2.4 BUSINESS GROUP IN EMERGING ECONOMIES.

Tarun Khanna and Krishna Palepu in their book (Winning in emerging market) define the emerging market through the institutional voids. [24]

They define emerging market by the lack of intermediaries which facilitate the transaction between sellers and buyers.

The purpose of these intermediaries is filling the essential institutional voids that come with any transaction. These intermediaries help to decrease the transaction cost between buyers and sellers.

In addition Khanna and Palepu cite another transaction cost, such as:

- The time required to start a business.
- The number of procedures to register a business.
- The time required to build a warehouse.
- The time required to execute a contract.
- The time required to register an asset.

Furthermore, in the emerging markets, obviously, there are diversity of market failures, resulted from agency problems and information asymmetry.

For instance, the lack of the precise disclosure of the financial market, and the fragile corporate governance and control, the absent or the weak evolving of the intermediaries such as, investment bankers, financial analysts, mutual funds and the financial press and Securities regulations are insufficient and their enforcement is inattentive.

Information asymmetries between management and the potential employer combined with the lack of human development agencies and business school that may mitigate this asymmetric information can cause a serious labor market failures. [25]

This information problems and lower level of literacy than developed economies make it costly to communicate the product's value. Therefore, labor and capital markets are characterized by spacious institutional gaps.

These kinds of intermediary's absence problems and the resultant transaction cost, reveal that a firm can often be more profitably operating as a part of a wide diversified business group, which may act as an intermediary between individual entities and imperfect markets.

The phenomenon of business group (corporate group) is ubiquitous in emerging economies and markets, such as India, Pakistan, Brazil, China, South Korea, Turkey, Thailand, Mexico and many more even in some developed countries.

These business groups generally consist of independent entities that operate in different activities (mostly unrelated) and industries and gathered together through formal bounds (equity) or informal bounds (family).

Business groups around the world vary frequently in shape and formation; some are highly diversified while others are more concentrated. Some of the business groups are involved in financial services such as insurance, banking and securities market. Whereas others are involved in industrial sectors which may ease the intragroup trade and the vertical integration among the group entities and production units.

These business groups are termed differently according to the economic environment or the country even if it still operates in the same concept as diversified firms. For instance business group in India are called business houses, while in Turkey under the name of Holding companies, and in Korea referred as Chaebols.

For more illustration for the scope of the business group, in spite of pluralism of studies of business groups in the literature, whereas, there are two visions to view business groups:

First one, which has bias to be based more in sociology, gives a wide definition of business group that focus on the multiplicity of relationships within the firm.

The second view, which tends to be based more in economics, focuses on the unrelated diversification as the base of the relationship.

The sociology-based definition of business group are so wide, concentrating on the multiple relationship that are embodiment so wide, concentrating on the multiple relationship that bond firms together in business group.

For instance Leff defines business group as "group of firms that does different business within a common managerial or financial control" that are bound by relation of interpersonal trust on the basis of the same personal ethnic or commercial background".[26]

Leff analyzed the business group in India or as it is called business houses and highlighted a vast array of relationships within the business houses (group) members, in each of these business groups, solid social links and bonds of family, ethnicity, language, caste and financial and organizational linkages between the affiliated units. Also Granovetter (Granovetter 1994) define business groups as a combination of firms linked or bound together in some informal and formal ways.

Later, in the same context Yiu, Bruton and Lu give the definition of business group as " a combination of legally independent entities that are tied by social ties such as kinship, family and friendship ties and economic ties such as financial, commercial and ownership ties ".[27] (Yiu, Bruton & Lu 2005)

Generally the economics-based definitions of business group are narrower, researchers and scholars highlighted unrelated diversification as the main feature of diversified business groups, presenting clearer difference from other types of networks of companies.

In addition, many of these economics-based definitions considered the ownership of the family as the second feature of business group.

For further illustration, Khanna and Ghemawat (1998) give the definition of business group as "an organizational form characterized by diversification among wide range of businesses interlocks between them, and in many situations under the family control". [28]

Another economics-based definition by Chang and Hong (2002), when they defined business group as a combination of formally independent firms under single common financial and managerial control, which controlled and owned by particular families. Later Fisman and Khanna (2004) defined business group as " a diverse set of business generally initiated by a single family, and linked together by common board membership and equity cross ownership".

Therefore, the majority of researchers who analyzed and studied business groups agree that the main characteristics of a business group are the unrelated diversification and the common control.

Less number of economists who accepted the respect of the ownership of family as the main characteristic for the business group, for example some economist specify the family part just to differentiate them from other types of conglomerates and other types of business networks. Table 4 showing some example for the empirical studies on business group and the core of these studies.

Table 4. Studies on business groups.

The study	The explanation (the core of the study)
Raja Kali (1999)	Argues the self structuring of the group affiliations as a result to contract enforcement by the legal system.
Maurer and Sharma (2001)	focused on the insufficient property rights'
Maitreesh Ghatak and Kali (2001) and Kali (2003)	argued the deficient information as another potential motive in the capital market
Almeida and Wolfenzon (2006)	offer a theoretic illustration for the structural of the pyramidal affiliated business groups which is based on the ability of controlling shareholders to have access to the cash flows of all group firms so as not to depend on underdeveloped external financial markets.
Chung (2001, 2006)	Discussed the reasons related to market forces, social institutions and culture on the development and the origin of affiliated business group. and also concluded the hardness of the separation of the related empirical importance of these factors.
Tsui-Auch (2005)	Propose the inclination through ethnic Chinese contractors in Singapore to form affiliated business groups and assign that this interesting observation is related to the heterogeneity in cultures of the community.

2.4.1 The Types of Business Groups.

Business groups can be viewed into three different types according to their ownership, these types are; family-owned business groups, state-owned business groups and widely-held business groups. [29] As these kinds are different in their ownership, control and management, they may result in different agency costs.

2.4.1.1 Widely-Held Business Groups

There is no specific majority of shareholder who can control the organization in widely-held business group. Ownership is distributed between many shareholders, decision making are generally controlled by professional managers, which have been nominated (assigned) by the board. These boards are controlled by managers from other big firms.

The agency problems of widely-held firms are the same with traditional agency problems resulted from the isolation of ownership and control. The result of this combination is that the managers may follow their personal objectives.

The separation of ownership may result in increased cost of funds, because shareholders are unwilling to invest in corporations where the managers are not performing in the right way to increase the shareholders wealth. [30]

Some of these widely-held business groups contain a bank as the major shareholder. This bank may provide both debt and equity to the group, for example in Spain; the government encourages the participation of banks to be both debt holder and shareholder for the firm in industrial sector. (Cuervo – Cazorra 1997)

Whereas, owner-debt holder agency problem is not a serious problem for the widely-held business group. Because owners generally have limited control to affect the managers to go through highly risk actions, at the same time generally managers are not concerned in risky businesses that may be the reason for corporation to bankruptcy.

Another advantage for the widely-held business groups is that they don't have additional employment conflicts, which can be held between managers and owners. Because managers who control the groups are generally the best of the available and are chosen by the board, which also mean promotion and remuneration is controlled by the board of directors.

2.4.1.2 State- Owned Business Groups.

From the given name of this type of business group, ownership is legally vested in the country's citizens. Control is exercised by the politician and civil servants.

These state-owned business groups are generally structured through the gathering of state-owned firms under a common organization umbrella. [31]

The formation of state-owned groups can be viewed as clear intervention of the government in the economy by the owner firms. This ownership is generally observed in communist countries like China. State-owned business groups basically suffer from the problems of agency due because of the isolation of control and ownership.

This type of business groups are symbolically owned by citizens, but managed by political parties and politicians. This may led to the result that many of these business groups are forced politically to undertake projects with small business value but high political gains.

Another problem is that many of the state owned business groups generally are not disciplined to the market, because of the political support, which make it difficult to access external funds, since shareholders are likely to invest in such a firm (Shleifer & Vishny, 1994).

State owned business groups may face owners and debt holder conflicts. Because politician may take decisions that are not economically beneficial. As a result lenders and private banks may be less attractive to lend to the state-owned business groups.

At the same time this type of business groups do not have serious additional employment conflict problems, because any political change may led to change the good and expert managers just for political reasons. (World Bank 1995)

2.4.1.3 Family-Owned Business Groups.

In this kind of business groups, individual or family members are involved in the control, management and ownership. Comparing to other types of business groups, there is no isolation or separation of roles. Even when selected professional managers

manage the corporation in some cases manage the corporation, these are under high supervision of the family. This may be the reason why the family owned business group do not suffer agency problem seriously like the other types.

There is an alignment of objectives between managers and owners that does not exist in other types of business groups in family-owned business group generally. [32]

Furthermore, hiring the family members as managers may solves the agency problem cost of the misbehavior of the management.

Meanwhile, family-owned business groups suffer from owner-debt holder agency problems, for example, when member firm in the affiliated business group is experiencing a bankruptcy problem, the family can coordinate the transfer of cash-flow and asset to other firms in the same organization before declaring bankruptcy. [33]

Another problem in this type of business groups is the additional employment conflict between family members and managers. Because the top managers are reserved for the family members Regardless of merit or abilities. Moreover the rewarding of professional managers may have ceiling lower than the average in the industry, while the owner managers are generally receive more income resulted from their ownership of the firm. This miss consideration and disregard of professional managers and the forcing of incompetent and unqualified family members may influence and affect the firm in bad way and be the dark side of family groups.

2.4.2 The Distinction between Business Groups and Conglomerates.

Business groups are generally defined as a combination of legally distinct firms that are bound together and coordinate on actions and decisions. (Khanna &Yafeh)

The linkages between member firms could be equity links or ownership through cross and pyramid share holding like those in Korean Chaebols, or family ties such as family business group in Turkey, debt ties such as Japanese Keiretsu, and ethnic ties such as International trading networks in China.

The most important characteristic of business groups is that each single firm in the business group is legally independent, which give those single firms the authorization to enter any legal contract by itself.

Moreover, in some cases some business groups are concentrated in one particular industry and not diversified.

For instance, firms in some business groups are operating in different industries. At the same, these firms are tied by either forward or backward linkages with other firms in the same business group, making the whole group undiversified by producing in one industry. This may led to the fact that corporate diversification and business groups are not necessarily synonym.

Business groups allow for varied combinations of ownership and shareholder through member firms. Each single firm of the business group is legally independent, so can have its special set of ownership and shareholder. (Hansmann and Henry 1996)

This flexible ownership may allow the business group's member firms to enter joint ventures with other, and conquer the legal restriction in ownership of foreign investors in some countries.

However, in conglomerate the characteristic of common ownership doesn't allow the firm to take advantage of separation of ownership and control through pyramid structure. [34]

The single legal entity of conglomerate does not allow the units to exploit the limited liability in the cases of bankruptcy.

While, in a business group each unit has its own liability since it is a judicial person.

Therefore, when any unit of the business group's units is experiencing financial distress or bankruptcy, other units (firms) are not obligated to that negative equity firm.

In other words, business groups may let a single firm to go bankrupt while a conglomerate cannot.

Another crucial point is that business groups have its own cost which is called as contracting cost that may arise from the heterogeneous collection of shareholders in the member firms. This cost may result from the conflict of interest between shareholders in different units. For example, the conflict between the minority shareholders in firms at the top and the bottom of a business group, when there is continuance internal capital tunneling from the bottom firms to the top firms due to the separation of control and ownership between the pyramid chains.

While in a conglomerate there is no such a conflict between the units since its all under one control.

Another difference between business groups and conglomerates is that business groups may suffer from the double taxation. [35] This may occur when firms in the bottom of the business group pay the income tax before the distribution of dividend to the top holding company; this dividend may be treated as capital income for the holding company and may be taxed again. (Zingales and Luigi 2000)

This problem may become even worse when the business group's chain get longer. Meanwhile, this double taxation problem is not observed in conglomerates.

Also conglomerates may enjoy the using of negative tax shield from unprofitable firms. Because conglomerates aggregate the net income from all units, which means that the positive net income could be reduced by the negative net income from the unprofitable firms.

Whereas, the tax in business groups is based on the sum of net income from profitable single firm within the group, which make the tax base in conglomerate lower then business groups.[36]

In sum, it can be argued that the main advantages of conglomerates are generally resulted from homogeneity of share holder combination and the lower tax rates while the advantages of business group mainly come from the flexibility in ownership combination and the limited liability of member firms in the case of bankruptcy.

2.4.3 Business groups in Turkey.

A growing field of empirical studies argued the business groups and its formation and effect in developing economies showing that generally affiliated business groups have a large and mostly positive effect on the financial performance of member firms.

The phenomenon of family business groups (holding companies) has a wide importance in Turkey.

90% of Turkish enterprises are family groups, 95% of medium and small sized enterprises in Turkey are family owned firms. This means that the dominant of the private sector business in Turkey is the family owned firms. [37]

Furthermore, the big holding corporations are generally family owned according to Istanbul Stock Exchange.

Family owned business groups are defined as the companies that 51% or more of its shares are held by families, these families' members are representing the majority of the senior management levels.

Turkey has made big changes in its economic policies at the early 1980s, when the Turkish government began to promote the culture of entrepreneurship.

These changes resulted considerable deregulation of capital and product market, causing to the increase of the domestic and international competition.

Later, relatively to these economic changes, business groups in Turkey should interact with these changes and make essential reforms in their structure and scope responding to these policy changes.

The members in business groups in Turkey are linked by common ownership of specific block of shares in group firms, generally by family, or holdings.

Each single firm of the holding company or the family business group is legally independent entity, which give these single firms the right to enter ventures and acquisitions.

The management of the family owned firms in Turkey are mostly characterized by some point that makes it differ from another types, for instance; [38]

- At least two generation of the families is involving in the management.
- Current or previous manager's children are taking part of management.
- The relationships of the family are playing the main role in the assignment of the top managers.
- The brand name of the company is developing with the family.

Turkish holding groups are traditionally relying on bank for its debt and equity to finance its activities and investments, this bank is often belong the same holding company, for example, Koç holding acquired 57% of Yapi kredi bank, and the main competitor for Koç holding is Sabanci holding which own more than 40% of Ak bank. This bank may facilitate the mechanism of internal capital transfer within the group's firms, since the cost of the internal capital fund in emerging countries is high, which give the holding family groups in Turkey the competitive advantage of the efficient internal capital fund unlike the unaffiliated firms.

Another feature for the family groups in Turkey is that they mostly contain a media under their umbrella, which make a big influence on people minds, Dyck and Zingales 2000 cited that people taking most of their information and knowledge through the media channels in generally. For instance, one of the main holding companies in Turkey (Doğuş Holding) is containing many of the leading media channels in Turkey such as Star TV, NTV, CNBC, and many more.

Finally, as a developing economy the basic characteristics of the corporate governance system of Turkey can be summarized as:

- There are few Turkish companies that are publicly traded and they exhibit highly concentrated and centralized ownership structures [Yurtoglu (2000)].
- The pyramidal ownership structures are observed widely

- There are institutional voids and operational deficiencies leading to serious market imperfections.
- The Istanbul Stock Exchange (ISE) has market imperfections which are mostly due to its thin and small nature.
- There are disclosure problems of the Turkish capital markets which lead to forming affiliated business groups as a solution

CHAPTER III

3.1 DATA AND METHODOLOGY.

This research thesis examines the effect of corporate diversification on firm value by using random effect panel estimation for the period 2001-2010 by concentrating on the Turkish listed manufacturing firms. The sample consists of 134 firms among which 79 are affiliated business group firms and 55 are unaffiliated individual firms.

Considering that, the main goal for corporation is to maximize the value of its shareholder which represented by the market price of the common stocks for this company (Van Horne, 1974)[39], the stock returns are used as a proxy for firm profitability, which is a distinctive feature of this study as past empirical research mainly focus on accounting based profitability measures such as return on assets, operating return on assets, return on equity etc. or on Tobin's Q as a market based performance measure.

As a mean of corporate diversification, group affiliation which is a widely used proxy for corporate diversification in emerging economies is used. Affiliated business group are defined by Khanna and Rivkin as "firms which though legally independent, are linked and bound together by a constellation of formal and informal ties and are accustomed to take coordinated action". These business groups are structurally different from conglomerates and are ubiquitous in many emerging markets".

Firm size, financial leverage, and stock index returns are used as control variables along with along with two dummy variables, namely the industry dummy and the group affiliation dummy.

Following Khanna and Palepu (1999) and Gunduz and Tatoglu (2003), firm size is used as a control variable to account for any potential effect of firm size on performance. Firm size is measured by the natural logarithm of the total assets.

As many researches and studies on the corporate diversification and firm performance cited a direct relation between corporate diversification and financial leverage such as Low and Chen (2004) who report a negative relationship between diversification and financial leverage, in the model financial leverage is also used as a control variable to account for the effects of financial leverage on firm performance. Financial debt ratio is calculated by dividing the sum of short and long term financial debt to total assets $[(\text{Short Term Borrowing} + \text{Long Term Borrowing}) / \text{Total Assets}]$ and is used as a proxy for financial leverage.

The stock market index return is used to control for the market movements and economic up and downs.

Besides, to account for the industry effects, two-digit industry codes are assigned to firms based on Istanbul Stock Exchange (ISE) industry classification.

Finally, to search for any difference between the performances of group affiliated and unaffiliated firms a group affiliation dummy is used. But, as group affiliation information is not readily available in Turkey, first of all it was necessary to determine which firms are affiliated under a business group. For this purpose, the ownership structures of the firms are derived from the balance sheet notes that are obtained from the ISE database. Besides, in order not to miss the implicit ties among the firms, the internet sites of the holding companies, groups and firms are examined. Figure 3 shows the group affiliation process.

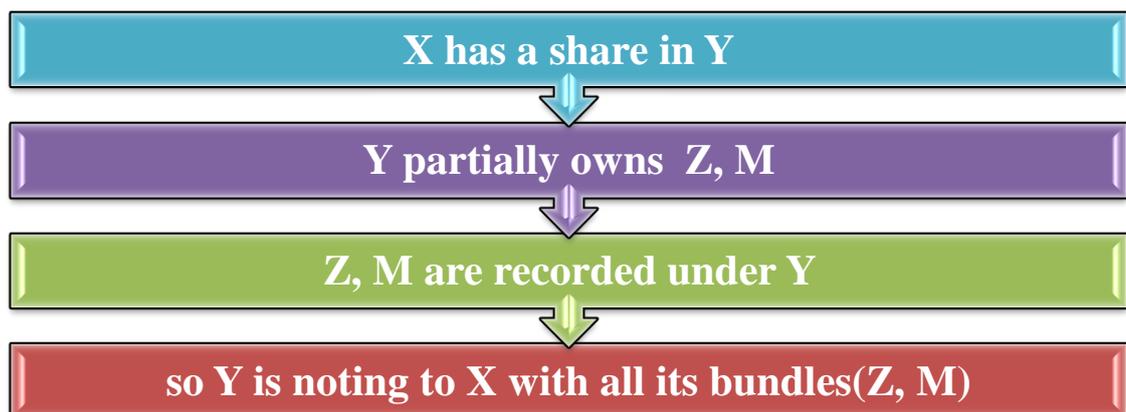


Figure 3: determining pyramidal business group ownership.

If the firm X has a share in firm Y, and firm Y is already owns share in firm Z and M, then the firm Y is recorded under the firm X with all it stakes (Z, M). In other word, firm Y is recorded with its entire links to Z and M under the ownership structure of X. The same in the case if a judicial person (Mr.K) has a share in firm Y, firm Y will be recorded with its bundles (Z, M) both under the ownership bundles of firm A and Mr.K. In this way the pyramidal structure of ownership was determined for the affiliated business groups in ISE.

This brings in the model below:

$$R_{i,t} = \beta_0 + \beta_1 Size_{i,t} + \beta_2 FinLev_{i,t} + \beta_3 R_{m,t} + \beta_4 D_{ind} + \beta_5 D_{gr} + \varepsilon \quad (1)$$

where;

$R_{i,t}$: denotes the stock return of ith company at time t,

$FinLev$: denotes financial leverage,

$R_{m,t}$: denotes the stock index return at time t,

D_{ind} : denotes the industry dummy, and

D_{gr} : denotes group affiliation dummy.

During the empirical analysis the above model is tested by using panel data. To search for the effect of business group affiliation on firm performance in terms of stock returns, the group dummy is used as the main variable which enables to distinguish between the affiliated and the unaffiliated firms. The group dummy is arranged in a way that the digit “1” is assigned to affiliated group firms and the digit “0” represents unaffiliated single firms.

The financial table data of the companies and the stock market index data of ISE are sourced from Bloomberg and the data of stock returns are calculated from the stock price data which are obtained from ISE database.

3.2 ANALYSIS RESULT.

The results obtained from the random effects panel estimation of the above model are provided in Table 5.

Table 5. Panel Estimation Results.

Variable	Coefficient
Constant	1.187679 (1.393306)
Size	-0.221633*** (-2.637222)
Financial Leverage	-0.374185 (-1.147537)
Return on Stock Index	6.767381*** (21.12092)
Group Affiliation Dummy	-0.267746 (-1.224683)
Industry Dummy	0.092464* (1.646967)

Notes: t-statistics are presented in parentheses.

***, **, * denote statistical significance at 1%, 5% and 10% levels, respectively.

As Table 5 reveals, group affiliation, though statistically not significant, seems to deteriorate firm value. However, since the probability of group affiliation dummy is 0.2209, this value deteriorating effect is insignificant at conventional levels where it should be below 0.10 to be considered as statistically significant at conventional levels. Hence, the findings neither report a value enhancing nor a value deteriorating effect of business group affiliation on firm performance in terms of stock returns. Rather, as this finding is not statistically significant at conventional levels, the findings suggest that there is no statistically significant effect of group affiliation on firm performance as measured by stock returns.

Further, the results also suggest that firm size negatively affects firm performance at 1% significance level and the sector in which the firm operates affects the firm performance at 10% significance.

CONCLUSION

Through referring to the process of operating in different product markets and industries, corporate diversification proves to be one of the essential strategic options that the corporation may execute to sustain growth and profitability. Accordingly, whether the corporate diversification has a value enhancing or a value deteriorating effect on the firm performance has been attracted the interest of many researchers around the world since the early 1950s and there is a big argumentation in the strategic management and the literature of finance in regard to the role played corporate diversification as a strategy for maximizing the value of share holder.

Although the theoretical arguments mostly claim corporate diversification to have a value enhancing effect, the past empirical evidence obtained for developed economies mostly suggested that diversified firms trade at a discount comparing with single-segment firms which have led the researchers to conclude that in developed economies the costs of diversification generally outweigh the benefits. However, due to the severe market imperfections which are also reinforced by asymmetric information and agency problems, and the institutional voids prevailing in the emerging economies, the relative costs and benefits of corporate diversification need not to be the same size. Actually, theoretically, highly diversified business groups are found to be essentially well suited to the institutional context in most emerging countries and there are good reasons to expect diversified corporations to benefit more from the efficiency enhancing functions relative to the firms operating in developed markets. Therefore, in emerging markets it can be expected that the benefits of corporate diversification will outweigh the related costs and it can be assumed that in emerging markets the effects of corporate diversification would be value enhancing or at worst less value deteriorating.

However, the empirical evidence for emerging economies provides contradictory results. Moreover, the findings are still not conclusive; there is still an open area to investigate the effect of corporate diversification on firm performance in emerging economies.

Following the aforementioned arguments, this research thesis attempts to investigate the effect business group affiliation which is a widely used proxy for corporate diversification in emerging markets, on firm performance in an emerging market, Turkey, by using random effect panel estimation for the period 2001-2010. Considering that, the objective of the firm is to maximize its value to its shareholders where value is represented by the market price of the company's common stock (Van Horne, 1974), the stock returns are used as a proxy for firm performance, which is a distinctive feature of this study as past empirical research mainly focus on accounting based profitability measures such as return on assets, operating return on assets, return on equity etc. or on Tobin's Q as a market based performance measure.

The findings suggest that there is no statistically significant effect of group affiliation on firm performance as measured by stock returns. Thus, diversified Turkish business groups are not found to outperform independent single firms in terms of stock market returns.

This finding provides support to the studies of Gunduz and Tatoglu (2003) who examined the performances of group affiliated and unaffiliated non-financial firms listed in ISE for the year 1999 and reported that "firms affiliated with diversified Turkish business groups do not differ significantly in terms of accounting and stock market measures of performance". Gonenc et al. (2005) also report no statistically significant effect of corporate diversification on firm value in terms of market based performance measure, Tobin's Q. [40]

This may be due to the fact that as business groups are mainly owned by a family in Turkey, the relative agency problems may not be that strong in Turkey. Another possible explanation may reflect that the market lacks to place a value for the benefits obtained through corporate diversification.

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