

The Moderating Effect of Managerial Ownership on Diversified Conglomerates and the Performance of Family Companies on the Indonesian Capital Market

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Abstract:

This paper investigates the effect of conglomerate diversification on company performance. Using industrial diversification and international conglomerates, this study examines the moderating effect of managerial ownership on the relationship between conglomerate diversification and the performance of family businesses that have managerial ownership and listed on the Indonesia Stock Exchange from 2010-2016. Using two proxies of performance, including accounting-based performance (ROA) and market-based performance (MBV). The empirical result indicates that industrial diversification shows positive and significant relationships with performance (ROA and MBV), while international conglomeration shows negative and significant relationships with performance (ROA and MBV). Further, managerial ownership has no moderating effect on a MBV of diversified companies. Regarding ROA, results show that managerial ownership has no significant effect on international diversification, however, for industrial diversification, ROA is significantly degraded. Meanwhile, using the level of managerial ownership, the results show that the level of managerial ownership has no moderating effect on performance, except that under lower managerial ownership, industrial diversification enhances ROA significantly, however, for international conglomerates, ROA is significantly degraded.

Keywords: *performance, family companies, industrial diversification, international conglomerate*

Introduction

Conglomerate diversification became a development trend during the twentieth century, including in Indonesia. Conglomerate diversification occurs when the value chain in each business unit is not the same, there is no relationship among its business units and competitively it has its own value (Hitt, Ireland, & Hoskisson, 2011; David F. R., 2011; Wheelen & Hunger, 2012). According to PT Central Data Mediatama Indonesia Consulting, throughout 2017, conglomerate business in Indonesia gained extraordinary profit (CDMI, 2018). Whilst the Indonesian economy grew gradually in the past three years and the global economy remained weak, most of their businesses even increased and continued expanding. A number of conglomerations have survived because their business is not only directed at one business sector, it also extends beyond the initial business field. Therefore, several conglomerations have successfully increased their total assets, revenue and profit. Consequently, the owners of the conglomerations persist in being some of the richest people in Indonesia with skyrocketing wealth.

Literature continues to debate whether diversification can benefit or conversely has a negative effect on competitive superiority ultimately. Alternatively, it is alleged that by means of diversification, companies can increase their economic scale, although certain findings have shown the opposite result. Therefore, strong scientific determination is required to bridge the difference (Chakrabarti, Singh & Mahmood, 2007; Delbufalo, 2016; Gyan, 2017).

Various studies have revealed a positive relationship between diversification and company performance after controlling endogeneity and indicate diversification premium (Olu, 2009; Lee, Hooy, & Hooy, 2012; Bhatia & Thakur, 2018). Premium diversification can be caused by the benefit obtained from efficient internal capital allocation (Rajan, Servaes & Zingales, 2000), higher tax protection (Mathur, Singh, & Gleason, 2004), technology and innovation (Santarelli & Tran, 2015), or risk reduction (Amihud & Lev, 1981; Sun & Govind, 2017). However, several studies also have revealed that diversification can reduce company value and that the diversified companies are valued lower than sole companies (Phung, 2015; Chang and Lee, 2016). Furthermore, Lamont and Polk (2002) and Stowe and Xing (2006), observed a diversification discount even after controlling the problem of endogeneity. Based on several research findings, the causes of the decrease in company value include: matter of agency (Jensen & Meckling, 1976; Khoroshilov, 2009) ; factor of dividend (Fazzari et al., 1988); efficiency of resource allocation (Lang & Stulz, 1994; Berge & Ofek, 1995; Rajan, Servaes, & Zingales, 2000; Lee, Hooy, & Hooy, 2012) ; economies of scope (Comment & Jarrell, 1995); the bargaining power between the companies in one division (Rajan et al., 2000); organisational competence (Matsusaka, 2001); company size (Santalo & Becerra, 2008); productivity (Schoar, 2002); company size and efficiency (Campa & Kedia, 2002), in addition to company growth (Gomes & Livdan, 2004). Furthermore, several other studies support the curvilinear relationship between diversification and firm performance (Palich, Cardinal, & Miller, 2000; Tefvik, 2008; Cho, 2013).

The forms of conglomeration business developed in Indonesia are predominantly family businesses. Data from Price Waterhouse Coopers (PwC) illustrates that approximately 95% of companies in Indonesia are family businesses (PwC, 2014). Along with the development of the family business, many expand into businesses that are completely different to the original business. More than 50% of public companies in Indonesia expand by doing conglomerate diversification strategy (Carney & Child, 2013; Claessens, Djankov & Lang, 2000). The companies are typically headed by a holding company that oversees various subsidiaries spread to allocate business segments. The following are the top 10 listed family companies in Indonesia that undertake conglomerate diversification, according to Globe Asia (Brahmana, Setiawan & Hooy, 2014).

The diversification situation in Indonesia is an interesting phenomenon to study, seeing that most companies are controlled by families who typically act only for the benefit of the controlling family, which potentially exacerbates the agency problem (Morck & Yeung, 2003). Besides, most developing countries do not yet have an advanced external capital market mechanism, whilst Indonesia is also considered as a country that has a weak institutional environment (Patrick 2001), where law enforcement is poor and there is no market control. Consequently, the process of capital allocation internally via diversification is dominant, especially for large companies. In addition, Indonesian businesses underwrite a higher currency risk due to the volatile Rupiah. Hence, the power of the conglomeration has become a very significant economic pillar in developing countries.

There have been several studies that examined the impact of conglomerate diversification in developing countries, i.e., Gyan (2017), examined the influence of conglomerate diversification on company performance in Malaysia with productivity as the moderating variable. It was found that industrial diversification and international conglomerate had no effect on company performance. Furthermore, Brahmana (2014), conducted a study on family businesses in Indonesia that undertook diversification strategy from 2006-2010 and realised that industrial diversification and international conglomerates have a negative effect on company value.

The inconsistency of the previous study regarding the relationship between conglomerate diversification and company performance in developing countries has encouraged the researchers to conduct further research. This study used managerial ownership as the moderating variable because managerial ownership is an excellent corporate governance mechanism. Managerial ownership helps control agency problems that occur because of the separation between ownership and company management. Share ownership by way of the manager is expected to increase the impact of diversification on company performance. This study also employed three levels of managerial ownership because most conglomerate businesses in Indonesia are

family companies where the management is controlled by the family who ordinarily acts only for the benefit of the controlling family, which potentially exacerbates agency problem (Morck & Yeung, 2003) and will ultimately affect company performance.

This study makes several contributions. First, results of this study can enhance financial literature concerning company expansion via conglomerate diversification in a developing country, Indonesia. Second, this study fills the shortage of the empirical findings of the effect of conglomerate diversification by means of industrial diversification and international conglomerate on company performance of family firms in Indonesia. Third, this study using managerial ownership as the moderating variable to investigate whether managerial ownership can moderate the relationship between conglomerate diversification and company performance. Finally, the renewal of this study is to develop three levels of managerial ownership as the moderating variable to determine which level of ownership can strengthen the relationship between conglomerate diversification and company performance.

Diversification

Diversification is a corporate strategy that is carried out to gain competitive superiority or to create corporate value above the average of competitors' by selecting and managing a number of different business units in several industries or with different products (Hitt, Ireland & Hoskisson, 2011). The implementation of diversification strategy in businesses has certain benefits and costs. The implementation of diversification strategy basically has two important implications: on the one side, diversification strategy can increase company profitability above those of the competitors; conversely, diversification strategy will add to the complexity of the company which can cause obstacles related to achieving the company's goals (Chakrabarti, Singh & Mahmood, 2007).

According to Montgomery (1994), there are three perspectives pertaining to company diversification. The first is the market power view, which views diversification as a medium to foster the influence of anti-competition that originates from conglomeration strength. The second one is the resources based view, which considers applying diversification to make use of the excess capacity of the resources owned by companies. The third one is the agency view, which views from the perspective of the relationship between shareholder and manager, which can cause agency problem due to differences in interests (Jensen, 1976). The managers who execute diversification will manage the process in accordance with their interests and it will ultimately have an impact on company performance. Furthermore, Erdorf (2012), explains the reasons why companies take the decision to undertake diversification, which consist of agency theory, efficient internal capital market theory, co-insurance theory and value maximization theory (Erdorf, Hartmann, Heinrichs & Matz, 2012).

Agency theory explains the separation between managers and shareholders. Certain agency problems that affect managers' desire to undertake diversification include increasing power, compensation and additional income (Jensen, 1986; Jensen and Murphy, 1990; Stulz, 1990), reducing personal risk that is closely related to company risk (Amihud & Lev, 1981; Liebenberg & Sommer, 2008) and defending themselves (Shleifer & Vishny, 1989; Hu & Kumar, 2004)

Efficient internal capital market theory explains the decision of managers to undertake company diversification strategy in order to create internal financing facilities, as there is the ability to cross subsidies among business units that require cash flows without the need for transaction costs and external supervision. Internal capital markets encourage companies to fund investment needs using capital, which can therefore be a source of value for companies (Stein, 1977; Gertner, Scharfstein, & Stein, 1994; Yan, Yang, & Jiao, 2010)

Co-insurance theory explains the combination of different business units in companies that undertake diversification strategy and incorrectly correlated cash flows that can reduce the overall company risk and enable the companies to fulfil debt obligations (Lewellen, 1971). Based on her study, states that the co-insurance effect has a notable benefit; the combination of different business units on company diversification enables companies with inferior cash flows to be subsidised by companies that have better cash flows.

Value maximization theory explains that managers make decisions relating to diversification, with the aim of maximising company value by performing an optimal combination of growth and company size. Empirical studies conducted by Maksimovic and Phillips (2002) and Gomes and Livdan (2004), prove that company diversification strategy is consistent with the principle of maximising company value.

Empirical studies that have been undertaken so far concerning the influence of diversification strategy on company performance in developing countries have not answered explicitly whether diversification strategy increases or decreases company performance. However, several empirical studies have shown the economic and financial benefits of company diversification strategy that can increase company value in both developed and developing countries. The economic benefits include operational and financial synergies, the ability to increase greater debt capacity, efficient internal capital markets, ability to reduce risks, besides tax protection. Empirical studies by Ramanujam and Varadarajan (1989), Robins and Wiersema (2003) and Damodaran (2005), explain that the benefits of company diversification are due to the effect of operational and financial synergies. Robins and Wiersema (2003), suggest that the connection among business units in a company portfolio can increase company value attributable to the benefits of economies of scope. According Martin and Sayrak (2003), the companies that undertake diversification strategy consider the benefits and costs of each decision and its effect on the company value more. Two forms of conglomerate diversification are developed in this study; specifically, industrial diversification and international conglomerate. Both forms of diversification strategy play an important role in the management of company strategy (Hitt, Hoskisson & Ireland, 1994; Denis et al., 2002; Brahmana, 2014; Gyan, 2017).

Diversification and Company Performance

Diversification undertaken by a company will have a different influence on company performance in various countries. Hence, the impact of diversification on the company depend on each company's situation or the economy in that particular country (Cakrabakti, Singh & Mahmood, 2007). Diversification will improve the performance of companies in the developing economic environment in a stable period, but not in an unstable economic situation. In general, in countries where the development of capital markets has not been established and the level of investor protection remains weak, the allocation of resources, including capital, is more directed internally. The presence of conglomerates that play a significant role in the economy of developing countries reveals that the internal mechanism of the capital market is more dominant. Several studies in developing countries confirm that companies that undertake diversification strategy will benefit from internal market efficiency due to the high cost of external capital markets (Lee, Hooy & Hooy, 2012). Furthermore, Khanna and Palepu (2000) state that company diversification is valuable in emerging markets due to inefficient capital markets, weak institutions and the high borrowing costs on financial markets. Based on the above review, the hypotheses are generated as follows:

H_1 : There is a significant positive relationship between industrial diversification and the performance of family businesses in Indonesia

H_2 : There is a significant positive relationship between international conglomerates and the performance of family businesses in Indonesia

Managerial Ownership Moderates the Effect of Diversification on Performance

Managerial ownership is a mechanism of good corporate governance (GCG). Managerial ownership helps solve the agency problems and improve company performance (Jensen & Meckling, 1976). The relationship between diversification and company performance will be strengthened by managerial ownership.

Based on the description, the alternative hypotheses proposed are as follows:

$H_{3.1}$: There is a significant moderating effect of managerial ownership on the relationship between industrial diversification and the performance of family businesses in Indonesia

$H_{3,2}$: There is a significant moderating effect of managerial ownership on the relationship between international conglomerates on company performance of family businesses in Indonesia

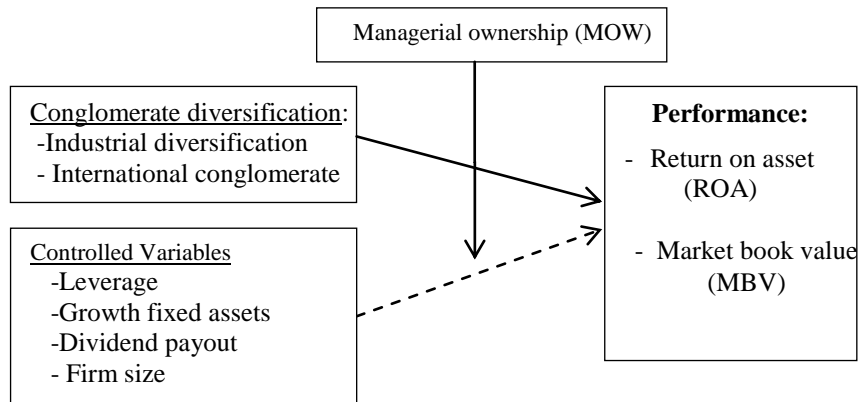


Figure 1. Conceptual Framework

Methods

The sample in this study were non-financial family companies listed on Indonesia Stock Exchange from 2010 to 2016. The sampling was conducted by way of purposive sampling, with the criteria a) Non-financial companies listed on the Indonesia Stock Exchange for the period 2010 to 2016; b) companies that have ownership and publish their financial statements for the period 2010-2016; c) companies that are not included in the category of financial companies (financial institutions, insurance companies and banks); d) The company is classified as a family company if 5% or more shares are owned by a family or at least there are two or more family members involved in the company. This refers to the definition of family companies and previous studies (Claessens, 2000; Villalonga and Amit, 2006; Holderness, 2009). Based on these criteria, the final sample composes 85 family companies or 595 observations, which consist of 420 observations for industrial conglomerates and 175 observations for international conglomerates. The regression is performed using panel regression.

This paper uses two performance measures, including accounting-based performance and market-based performance as the dependent variable. Accounting performance measures return on asset (ROA), calculated as earnings after tax divided by total assets. Market performance measures market-to-book ratio (MBV), calculated as the market value to the book value of equity (Jermias, 2008; Vieira, 2017). This study used the categorisation approach for the conglomerate diversification measure. This approach was originally developed by Fauver, Houston & Naranjo (2004) and was subsequently modified by Lee, Hooy & Hooy (2012) and also used by Brahmna, Setiawan & Hooy (2014) and Gyan (2017). This study also used control variables related to company characteristics, namely capital structure, growth fixed asset, dividend policy and size. In previous studies, several factors that influence company performance; either the profitability or the value of company. This study uses company characteristics, such as capital structure, payout ratio, size, growth fixed asset and productivity. Capital is measured by using the ratio of debt to common share equity (Brahmana, Setiawan & Hooy, 2014). The dividend payout ratio is the ratio of the total amount of dividends paid out to shareholders relative to the net income of the company that is measured by the percentage of a paid income. Growth is the growth of a fixed asset that is measured by the ratio of the increase of the fixed asset. To measure size, we use the total assets of the company as a proxy (Gyan, 2017).

Conglomerate diversification is the development of the business by entering different industries that are completely different from the early establishment of the company. The type of conglomerate diversification differs from one company to another. Diversification of a conglomerate is categorised into industrial conglomerate (Dcog) and international conglomerate (Dintcog). This study uses a conglomerate

diversification measure by means of a categories approach (categorisation approach) by using dummy variables, such as those employed by Gyan (2017) and Lee, Hooy & Hooy (2012).

$$D_{COG,it} \begin{cases} 1: \text{if firm has } > 1 \text{ segment} \\ 0: \text{if firm has } \leq 1 \text{ segment} \end{cases}$$

$$D_{INTCOG,it} \begin{cases} 1: \text{if firm has } > 10\% \text{ foreign sales and } > 1 \text{ segment} \\ 0: \text{if firm has } \leq 10\% \text{ foreign sales or } \leq 1 \text{ segment} \end{cases}$$

In this final model, managerial ownership is estimate to shows its effect on relationship between diversified conglomerates- and performance. The model shows the effect of interactive term of managerial ownership and diversification on the performance.

$$Performance_{i,t} = \alpha_0 + \beta_1 LEV + \beta_2 DPR + \beta_3 GFA + \beta_4 SIZE + \beta_5 D_{IND} + \beta_6 D_{INTIND} + \beta_7 MOW + \beta_8 D_{IND} \times MOW + \beta_9 D_{INTIND} \times MOW + \epsilon_{i,t}$$

Results and Discussion

The following are the results of the descriptive analysis of each study variable in 89 non-financial companies that comprise managerial ownership and were listed on the Indonesia Stock Exchange from 2010-2016:

Table 1. Decriptive Analysis

Variable	Mean	Media n	SD	Min	Max
MBV	2.042	0.127	1.998	0.100	16.34
ROA	0.073	0.059	0.060	0.002	0.460
Dcog	0.706	1	0.456	0	1
Dintcog	0.281	0	0.449	0	1
MOW	0.066	0.052	0.073	.0001	0.388
DER	1.130	0.855	0.920	.071	4.460
GFA	.147	0.102	0.259	-.702	1.093
DPR	.153	0	0.213	0	0.985
SIZE	14.577	14.573	1.623	10.659	19.383

Table 1 report the summary statistics on the variables used in analysis of the full sample for family ownership companies that have managerial ownership. MBV is market book value to book value of the equity. ROA is the net income divided by total assets. Dcog is industrial diversification. Dintcog is international conglomerate diversification. DER is ratio of total debt divided by equity. GFA is growth fixed assets. DPR is dividend pershare divided by earning per share. Size is measured as natural logarithm of the book value of total assets. MBV is has a mean value of 2,042, showing that on average family company have a higher MBV. Further, ROA has a mean value of 7.3 percent, showing that on average have a higher ROA.

Diversification – Performance and Managerial Ownership Analysis

The regression is performed using four models. The dependent variable is the performance. This study uses two latent constructs to measure the performance in order to illustrate the analysis strength; namely accounting performance that is measured by using return on asset (ROA) and market performance that is measured by applying the market to book ratio (MBV). The independent variables are the industrial

diversification (Dint), international conglomerate (Dintcog). The control variables are capital structure (DER), growth fixed asset (GFA), dividend payout (DPR), and Size. The results of the study is as follows:

Table 2. Regression Analysis

	<i>Performance (ROA)</i>		<i>Performance (MBV)</i>	
	<i>Model 1</i>	<i>Model 2</i>	<i>Model 1</i>	<i>Model 2</i>
<i>Constant</i>	-1.278*** (0.000)	-1.290*** (0.000)	-0.342** (0.012)	-0.290** (0.049)
<i>Dcog</i>	0.154*** (0.000)	0.212*** (0.000)	0.192*** (0.000)	0.235*** (0.000)
<i>Dintcog</i>	-0.162*** (0.000)	-0.173*** (0.000)	-0.161*** (0.000)	-0.177*** (0.000)
<i>MOW</i>		0.395 (0.205)		0.033 (0.911)
<i>Dcog*MOW</i>		-0.871** (0.047)		-0.642 (0.173)
<i>Dintcog*MOW</i>		0.201 (0.669)		0.294 (0.560)
<i>DER</i>	-0.141*** (0.000)	-0.140*** (0.000)	-0.011 (0.486)	-0.012 (0.441)
<i>GFA</i>	0.204*** (0.000)	0.208*** (0.000)	0.204*** (0.000)	0.207*** (0.000)
<i>DPR</i>	0.235*** (0.001)	0.239*** (0.001)	0.377*** (0.001)	0.386*** (0.001)
<i>SIZE</i>	0.003 (0.770)	0.002 (0.860)	0.022** (0.023)	0.018* (0.071)
<i>Observation</i>	595	595	595	595
<i>.R²</i>	0.252	0.258	0.188	0.193
<i>Adjusted R²</i>	0.245	0.247	0.179	0.180

Significant Level: p<0.1; ** p<0.05; *** p<0.01

The estimates of model 1 use conglomerate diversification with regards to company performance. The results reveal that industrial diversification has a positive effect on Performance (ROA and MBV) at a significant level of 1%, otherwise the diversification of international conglomerate has a negative effect on performance (ROA and MBV) at a significant level of 1%. Model 2 includes managerial ownership as the variable that moderates the connection of industry diversification and international conglomerate. The findings indicate that managerial ownership has a significant negative moderate the relationship between conglomerate diversification and company performance (ROA), whilst managerial ownership show no significant moderating impact on international conglomerates. Further, Managerial ownership not significant moderator relationship between diversified conglomerate (Dcog and Dintcog) and performance (MBV). Lastly, capital structure, payout ratio, growth fixed and size as the control variables with regards to company performance by using accounting-based performance (ROA). The results reveal that capital structure had a negative effect on performance (ROA and MBV) at a significant level of 1%, whereas growth fixed asset and dividend payout, had a positive effect on performance (ROA and MBV), except size no significant effect on ROA.

The result of the first hypothesis shows that industrial diversification (Dcog) has a positive and significant effect on company performance (ROA and MBV). Therefore, based on the research, it can be concluded that the strategy diversification completed by the company is operating effectively, having a positive impact and furthermore, improving company performance. The results of this study support the findings obtained by Olu (2009) and Lee, Hooy & Hooy (2012), which state that diversification is more profitable for a company in a developing economy. The results of this study support the assumption of internal market efficiency, which explains the manager's decision to undertake a company diversification strategy that is caused by the ability of diversified companies to transfer capital from one company to another without causing additional transaction costs. The positive benefits of industrial diversification can also be caused by tax reduction benefits regarding the mechanism of internal transactions. It encourages an increase in share prices and creates diversification of premiums and therefore, increases the value of the company (Berge & Ofek, 1995;

Singh, Mathur & Gleason, 2004). Then according to (Chang & Hong, 2002), business diversification can assist companies to avoid market failures that commonly occur in developing countries.

The result of the second hypothesis indicates that international conglomerates (Dintcog) has a negative effect and it is significant in relation to company performance either accounting-based performance (return on asset- ROA) or market-based performance (market book value- MBV). It can be caused as the international conglomerate has greater foreign sales, which is vulnerable to company income when the cost of domestic production is much higher than in foreign countries. The negative impact of this international conglomerate can also be caused by the conglomerates exceedingly large debts and the source of funding to conduct expansion comes in the form of loans from other countries. Additionally, some are partnering with foreign investors to achieve this aim (CDMI, 2018). The impairment of the Rupiah exchange rate could possibly be one of the causes of the decline in the performance of international conglomerates. Besides, international conglomerates have investment opportunities that are more diverse and more complex, so they have a greater risk (Rajan et al., 2000). A further problem that arises is that there is a cost pertaining to information asymmetry that arises between central management and division managers. Diversified companies will face agency costs that increase along with the increasing complexity of their organisational forms (Denis et al., 1997). This can lead to the phenomenon of diversification discount.

The subsequent hypothesis test includes managerial ownership as the moderation variable, to verify whether or not managerial ownership has a role in relation to the connection of industrial diversification and international conglomerate and company performance. The results show that managerial ownership has no moderating effect on relation between industrial diversification conglomerate and company performance, except that under industrial diversification managerial ownership can moderate the relationship between industrial diversification and company performance, but it has a debilitating effect, which is that increasing managerial ownership can weaken the positive influence of industrial diversification on return on asset.

The manager's decision in carrying out the strategy of company diversification is triggered by the desire to increase the value of the company and his personal interests, in addition to the possibility of being replaced. Certain agency problems that affect managers' desires to make company diversification decisions are partly driven by the desire to increase power, compensation and extra income (Jensen, 1986; Jensen and Murphy, 1990; Stulz, 1990), so as to reduce the personal risks that are closely related to risk (Amihud and Lev, 1981) and as an attempt to defend themselves (Shleifer and Vishny, 1989). According to agency theory, managers tend to overinvest or generate empire building (Williamson, 1975; Donaldson, 1984) and always attempt to maintain growth beyond the optimal size limit. This case can produce agency problems that can decrease company performance. According to Denis (1977), the levels of diversification is negatively related to managerial equity ownership. The results also showed the occurrence of entrenchment effects. Entrenchment hypothesis states, the greater the proportion of share ownership held by management, the greater the likelihood that management will be encouraged to prioritise their personal interests rather than the interests of capital owners to increase the value of the company, as they have considerable voting rights and bargaining power. Diversification strategy that is carried out by managers may have different results than those expected by the owner due to different interests. The consequence of this finding is that conglomerates in Indonesia need to pay attention to the size of managerial ownership, in order to improve company performance.

Conclusion

The results of the study showed that industrial diversification had a positive effect on company performance, by means of using both proxies of performance (ROA and MBV). On the contrary, international conglomerate had a negative effect on company performance, also measured using ROA and MBV. The results support efficient internal capital market theory which explains the managers' decisions to undertake company diversification strategy due to the ability of diversified companies to transfer capital from one company to another company without causing excess costs on transaction. However, along with the

increasing complexity of the form of their organisation, the policy can cause the phenomenon of diversification discount. The results of this study also revealed that managerial ownership could moderate the relationship between conglomerate diversification and company performance, although it had a weakening effect. This indicates the occurrence of agency problems in companies that undertake diversification in Indonesia. Furthermore, the control variable 'leverage' showed a negative and significant relationship between leverage and company performance both in the form of ROA and MBV. Conversely, other control variables, specifically company size, fixed asset growth and asset productivity had a positive effect on company performance.

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