DIVERSIFICATION AND FIRM VALUE: ANALYSING THE ROLE OF MANAGERIAL ABILITY, CORPORATE GOVERNANCE AND CEO CHARACTERISTICS

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DIVERSIFICATION AND FIRM VALUE: ANALYSING THE ROLE OF MANAGERIAL ABILITY, CORPORATE GOVERNANCE AND CEO CHARACTERISTICS

by

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DIVERSIFIKASI DAN NILAI FIRMA: ANALISIS PERANAN KEUPAYAAN PENGURUSAN, GOVERNAN KORPORAT DAN CIRI KETUA PEGAWAI EKSEKUTIF

ABSTRAK

Diversifikasi merupakan satu strategi pertumbuhan yang sangat popular dalam kalangan firma Malaysia. Namun begitu, dengan penemuan diskaun diversifikasi sejak tiga dekad yang lalu, adalah penting untuk firma Malaysia menilai semula sama ada diversifikasi mencipta nilai kepada firma. Kajian ini meneroka sama ada keupayaan pengurusan memainkan peranan dalam hubungan antara diversifikasi dan nilai firma melalui penanganan teka-teki premium/diskaun diversifikasi. Di samping itu, kajian ini turut mengaji atribut peribadi CEO yang sesuai dengan diversifikasi firma, satu tujuan yang dimotivasikan oleh teori echelon atas. Tambahan pula, teori agensi menunjukkan bahawa pengurus mempunyai kecenderungan untuk terlibat dalam isu agensi. Oleh itu, kajian ini menyelidik sama ada pengaruh penyederhanaan keupayaan pengurusan terhadap hubungan antara diversifikasi dan nilai firma akan dapat dipertingkatkan apabila firma mempunyai mekanisme tadbir urus korporat yang baik. Sampel data merangkumi semua firma tersenarai di Bursa Malaysia untuk sembilan sektor: produk pengguna, pembinaan, produk industri, teknologi, IPC, hotel, perladangan, hartanah, serta perdagangan dan perkhidmatan. Data tahunan firma selama sembilan tahun (2009 hingga 2017) diperolehi daripada pangkalan data Datastream/Worldscope. Maklumat mengenai atribut CEO (umur dan pendidikan) dan tadbir urus korporat (nisbah pengarah bebas dan dualiti) dikumpul secara manual daripada laporan tahunan firma. Ukuran keupayaan

pengurusan dianggar menggunakan kaedah yang dimajukan oleh Demerjian et. al. (2012). Hasil kajian menunjukkan bahawa pengurus yang berkebolehan tinggi membawa kepada nilai firma yang lebih tinggi. Lebih penting lagi, apabila keupayaan pengurusan memainkan peranan, hubungan antara diversifikasi dan nilai firma berubah secara signifikan daripada negatif kepada positif. Selanjutnya, kajian ini menunjukkan bahawa umur CEO, latar belakang pendidikan, dan mekanisme tadbir urus korporat, khususnya lembaga pengarah bebas dan dualiti CEO, dapat meningkatkan lagi pengaruh positif keupayaan pengurusan terhadap hasil nilai firma daripada diversifikasi secara signifikan. Hasil kajian juga didapati kukuh apabila ROA dan ROE digunakan sebagai ukuran nilai firma. Hasil kajian mempunyai beberapa implikasi teori dan dasar. Kajian ini mengaitkan perspektif berasaskan sumber dan hasil diversifikasi untuk mencari hubungan penyederhana antara diversifikasi dan nilai firma. Apabila melantik CEO, lembaga firma harus menilai keupayaan pengurusan CEO. Firma yang dipelbagaikan lebih berkemungkinan mendapat manfaat daripada diversifikasi sekiranya mereka menggaji CEO yang lebih berumur dengan tahap pendidikan yang lebih tinggi, mempunyai struktur kepimpinan yang berasingan dan mempunyai majoriti lembaga pengarah bebas.

DIVERSIFICATION AND FIRM VALUE: ANALYSING THE ROLE OF MANAGERIAL ABILITY, CORPORATE GOVERNANCE AND CEO CHARACTERISTICS

ABSTRACT

Diversification is a hugely popular growth strategy among Malaysian firms. However, in light of the diversification discount and subsequent refocusing efforts of Western firms in recent decades, it is essential to re-examine whether diversification creates value for firms critically. Addressing the diversification premium/discount conundrum, this study explores whether managerial ability influences the relationship between diversification and firm value. In addition, this study examines CEO personal attributes that are compatible with diversified firms, an aim motivated by the upper echelon theory. Furthermore, agency theory demonstrates that managers have the tendency to be involved in agency issues. Thus, this study investigates whether the moderating effect of managerial ability on the relationship between diversification and firm value will be further enhanced when firms have good corporate governance. The sample data includes all KLSE-listed firms across nine sectors: consumer products, construction, industrial products, technology, IPC, hotel, plantation, properties, as well as trading and services. Nine years (2009 to 2017) of firm annual data were collected from the Datastream/Worldscope database. Information on CEO attributes (age and education) and corporate governance (ratio of independent director and duality) was manually collected from annual reports. The managerial ability measure is estimated using Demerjian et al. (2012)'s method. The findings offer evidence that high-ability managers

lead to higher firm value. More importantly, when managerial ability comes into play, the relationship between diversification and firm value changes from significant negative to significant positive. This study further shows that CEO age, education background, and corporate governance mechanisms, in particular, independent board of directors, and CEO duality, can further enhance the significant positive influence of managerial ability on the value outcome of diversification. The results are also robust with the use of ROA and ROE as a measure of firm value. The findings have several theoretical and policy implications. This study links the resource-based perspective and the outcome of diversification to find a moderating relationship between diversification and firm value. When appointing CEOs, the board should evaluate their managerial abilities. Diversified firms are more likely to benefit from diversification if they employ older CEOs with higher education levels, have a separate leadership structure, and have a majority of independent board of directors.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

As a research topic, corporate diversification has a lengthy and illustrious history. In general, diversification strategies can take many forms. These include product diversification (operating in multiple industries), geographic market diversification (operating in multiple geographic markets, often multiple countries), and product-market diversification (operating in multiple industries in multiple geographic markets).

Corporate diversification is a hot topic in various fields. However, financial research has mainly concentrated on two key topics: the impact of diversification on (i) firm value and (ii) financial management. The impact of diversification on firm value is arguably one of the most researched and debated topics in academia. Nevertheless, theoretical studies have not precisely predicted whether diversification is a beneficial or detrimental strategy. At the same time, the findings of past empirical studies on the value of diversification are contradictory and ambiguous.

The rise of diversified firms in the United States of America during the 1950s and its rapid growth during the 1960s and 1970s was ignited by the economic and institutional conditions at the time (Colpan & Hikino, 2018). These factors, together with the antitrust act, prevented horizontal expansion of firms, causing lack of external funding for small firms, abundance of cash flow, and low-interest loans for well-established firms (Anand and Jayanti, 2005). Therefore, many firms, particularly those in the declining market, faced the vital need to move into unrelated businesses. On the other hand, emerging countries in Asia such as Malaysia were still underdeveloped in terms of product, labour,

and capital markets. As a result, many entrepreneurs in these countries were unable to secure enough capital to start their production of goods and services. As long as these "institutional voids" remain, there were substantial unfulfilled demands for goods and services in these markets. Sensing the opportunity, coupled with the economic and institutional conditions in these emerging economies, many well-established USA firms began investing heavily in Asia.

The United Kingdom (UK) also observed the rise of diversified firms during the 1960s. The financial market was also more than supportive of such unrelated diversification growth, providing an abundance of capital for acquisitions (Colpan & Hikino, 2018). Similarly, many family-owned firms in Italy, such as Fiat, rapidly shifted their business domain from automobiles into unrelated businesses such as distribution, insurance, toll highways, office machine manufacturing, construction, and food products during the 1960s and 1970s at the international level (Colli & Vasta, 2015). The 1980s marked the start of the decline of diversified firms in Western developed economies. During the early 1980s and 1990s, many diversified firms were found to be lacking competitive capabilities in the industries they entered. Lang and Stulz (1993), who used Tobin's Q as the performance measure, found that focused firms had higher values than diversified firms. They conclude that bad performance encourages diversified firms to look for opportunities for expansion, but the strategy does not necessarily result in an improvement in the performance of the firms. Based on their examination of data from the United States for the years 1986–1991, Berger and Ofek (1995) came to the same conclusion, confirming that diversification reduces the value of a company by an average of 13% to 15%.

With the discovery of "diversification discount" (the firm value of diversified firms is lower than the total sum value of its segmental businesses), many firms were forced to restructure or refocus under the capital market pressure. In America, many diversified firms were under fire during the 1980s due to their underperformance (Colpan & Hikino, 2018).

It was also believed that most of the top management of these firms lacked the ability to manage the diverse businesses operating in unrelated product and geographical markets. Managers must effectively process a sizable amount of information in order to handle the high number of complicated transactions and make decisions regarding the allocation of resources and choice of strategies. For instance, in order to operate effectively, managers may need to restructure marketing initiatives and create new distribution networks given the variety of competitors, their various strategic orientations, and the variety of customers (Hitt et al., 2001).

According to Anand and Jayanti (2005), many of the top managers were overwhelmed by the decision-making related to allocating capital to subsidiaries asking for investments. These executives often acted like poor-performing banks, lending capital without due diligence and information, subsidising poor-performing segments with the profits made from well-performing ones. The increase in corporate tax rates and interest rates further slowed the diversification of firms that originally grew under low-interest loan funding arrangements. Once the unfavourable scenario for many earlier diversified firms was set, shareholders began to exert pressure on the majority of diversified firms to consolidate their product lines and concentrate on their most profitable segments.

During the mid-1990s and early 2000s, research was expanded to encompass additional developed economies, such as Germany, Japan, and the United Kingdom (Lins

& Servaes, 1999, 2002). Most of these studies concluded that firm diversification decreases its value (Aggarwal & Samwick, 2003; Berger & Ofek, 1995; Denis et al., 1997; Denis et al., 2002; Fauver et al., 2003; Fleming et al., 2003; Mansi & Reeb, 2002). During this time, the increase in shareholder pressure was not limited to American firms. Diversified businesses in the UK, Sweden, Belgium, and Australia faced similar situations. Institutional investors were particularly hostile to firms that diversified into unrelated businesses, causing their share prices to plummet. Certain UK firms, such as Hanson Trust, BTR, and Grand Metropolitan, were performing well but were forced to restructure due to shareholder opposition to unrelated diversification (Colpan & Hikino, 2018).

However, several others (see, e.g., Villalonga, 2000a; Whited, 2001; Chevalier, 2000; Campa & Kedia, 2002; Mitton & Vorkink, 2010) have openly challenged the validity of the findings on different grounds. As a result, the literature continues to be perplexed by the value of diversification. When a firm engages in diversification, the strategy could involve purchasing assets and entering into joint ventures with partners. However, acquisitions could go wrong by purchasing poorly managed assets (Graham et al., 2002), and joint ventures could end up partnering with poor performing firms. These poorly executed transactions are likely to cause diversification discounts and lead to the wrong conclusion that diversification destroys value. Therefore, a critical implication of the diversification discount or premium argument is that the value of diversification could depend on a variety of factors.

According to Stein (2003), researchers should pay greater attention to the cross-sectional variations in diversification value, i.e., they should find the particular circumstances in which diversification is either a value-creating or a value-destroying

strategy. Since the early 2000s to the present, researchers have begun to focus more on emerging economies (Chakrabarti et al., 2007; Salamudin & Daud, 2009; Zheng & Tsai, 2019), where circumstances such as corporate governance, market power, and agency problems differ from those in developed nations. According to Ayoib et al. (2003), 53% of Malaysian companies reported having multiple segments in 1995. Lins and Servaes (2002) reported that 47% of Malaysian firms were diversified, and Malaysia was the most diversified country among seven East Asian countries in their study based on the 1995 sample database. More importantly, Lee et al. (2019) observed a pattern of increasing Herfindahl index from 2010 to 2015. This suggests that Malaysian firms have expanded into a wider number of sectors in recent years.

Why do Malaysian companies continue to aggressively diversify their business operations? The plausible response to this question is often based on the distinctive institutional environment of emerging nations such as Malaysia. According to Khanna Palepu (2000), under the assumption that emerging market firms operate in less developed and inefficient capital markets, these firms would have a greater incentive to diversify into other varieties of industries in order to create internal capital markets to supplement their weaker external financial markets. They also noted that the survival of focused firms in developing markets is difficult due to the problems of imperfections related to capital markets, labour and product markets, treaty enforcement, government regulations, and business relations. Diversification is a natural response of companies confronted with the reality of "institutional voids" in emerging economies.

The plausible explanation for why emerging-market firms continue to diversify implies that a better understanding of the cross-sectional variance of corporate diversification and firm value is required. Diversification itself may not be a good or bad

strategy. The value of diversification is contingent on other factors. Identifying the factors that contribute to the success of diversification for some firms but not for others is crucial for managers, as it provides guidance on how to maximise firm value through the implementation of a diversification strategy. Previous research has established that the relationship between diversification and firm value is influenced by the effectiveness of internal capital markets, the degree of diversification, organisational learning, and corporate governance.

This study suggests that managerial ability is one of the factors that influence the relationship between diversification and firm value. The impetus comes from prior evidence that establishes a positive relationship between managerial ability and firm performance (Bamber et al., 2010; Chemmanur et al., 2010; Demerjian et al., 2013; Choi et al., 2015; Andreou et al., 2016; Francis et al., 2016). The ability-based explanation of this study focuses on the difficulty in managing a diversified firm. This study follows the argument made by Erdorf et al. (2013) that corporate diversification alone does not determine the discount or premium. Firms choose to diversify when the benefits outweigh the costs of diversification.

The benefits of diversification are typically realised through synergy or spillover between business lines. The CEO is responsible for maximising the potential value of these synergies. Some managers of diversified firms may have been overwhelmed by the volume and complexity of decision making, resulting in poor firm performance. Logically, it is reasonable to expect that high-ability managers will exercise superior judgement and make better decisions, thus contributing significantly to the performance of respective firms. To our knowledge, most of the existing literature does not consider managerial ability as a conditional factor. As such, this study directly contributes to a large body of

research (see, e.g., Sautner & Villalonga, 2010; Ozbas & Scharfstein, 2010) on the cross-sectional variation of diversified firms by showing that diversification value varies with the managerial ability of firms.

In conclusion, while the "u-turn to specialisation" trend for diversified firms in western developed economies, especially during the 1980s to early 2000s, there is no sign of slowing down in the diversification activities undertaken by developing Asia firms. Considering the impact of the discovery of diversification discount on subsequent refocusing efforts of many diversified firms in the West, one should not lose sight of the potentially similar impact on firms in emerging economies in Asia. Therefore, in the following sections of chapter 1, this study will examine corporate diversification activities in Malaysia and further explore the theoretical and empirical findings of diversification discount that plague the diversified firms in the west during the last decades.

1.2 Problem Statement

After nearly three decades of extensive research, in recent years, a consensus has emerged that corporate diversification would result in lower valuations or poorer performance for firms (Lee & Hooy, 2018). Despite the negative findings against diversification efforts, Malaysian CEOs have been quite active in implementing diversification strategies across industries (Ayoib et al., 2003; Lins & Servaes, 2002). For instance, Claessens et al. (2001) reported that, on average, 70% of Malaysian firms are multi-segment compared to only 20% for U.S. firms based on data from 1990-1996. Similarly, Lins and Servaes (2002) studied seven East Asia countries using data from 1995, and contended that Malaysia has the highest percentage of diversified firms (47%) among the seven countries. The findings were supported by Ahmad et al. (2002). The study reconfirmed the popularity of

diversification strategies among Malaysian firms using data for 1995. They revealed that most Malaysian firms were involved in three to four business segments and 53.9% of the public listed firms are diversified firms.

Thirty over years since the start of corporate diversification in Malaysia, today, firms such as AirAsia, Genting Berhad, IJM Corporation, YTL corporation and UMW Holdings Berhad are well represented in the vast field of business segments. For example, AirAsia currently provides air transport, travel, and lifestyle products and is involved in e-commerce, logistics, and fintech. Genting Berhad has a wide range of businesses, covering leisure and hospitality, life sciences and biotechnology, energy, plantations, and property development. IJM has its core businesses in construction, property, industry, and infrastructure. YTL Corporation Berhad also involves in various businesses such as construction contracting, telecommunication, hotel development and management, cement manufacturing, e-commerce, property development and investment, and utilities. UMW Holdings Berhad is currently engaged in multiple business segments ranging from aerospace, automotive, equipment to manufacturing and engineering.

To the extend, Bank Negara Malaysia issued a framework for Malaysian firms to reconsider their growth strategies to be in tune with the new megatrends of Industry 4.0 and climate change in 2018. While acknowledging that diversification is typically a high-risk strategy, Malaysian firms were urged to diversify further, look for opportunities beyond existing know-how and venture into more complex industries. An example provided in the BNM report was for laboratory equipment and apparatus manufacturers to diversify into manufacturing instruments for physical or chemical analysis (BNM, 2021). While the mission might be successful in the long run, it also presents a significant challenge to business managers because it requires upgrading a company's technological

and production capabilities beyond what is currently possible. This is in addition to tasks like resource allocation, marketing, and distribution that are related to diversification. Ever since the notion that the existence of firms is to serve the interests of its shareholders became widespread, it had been widely accepted that any production undertaken by firms must be in the pursuit of profit and create value for the firms (Barney, 1986; Makadok, 2001).

However, given the continued growth of diversification among Malaysian firms, it is essential to appraise critically: Does diversification create value for firms? Taking into account the recent consensus that diversification leads to a discounted firm value and the continued popularity of diversification strategy among Malaysian firms, there is a cause of concern for Malaysian diversified firms. However, firms typically benefitted from diversification through synergy or spill over. Nonetheless, some managers of diversified firms may have been overwhelmed by the amount and complexity of decision making, resulting in poor firm performance. In this regard, managerial ability can moderate the value outcome of diversification. Diversification may not necessarily result in lower firm value. A highly capable manager will be able to overcome any obstacles that a diversified company may confront, realise the potential gains from diversification, and subsequently reward shareholders with higher firm value.

1.3 Research Gap

The reason managerial ability had been chosen as a factor in this study was that managerial ability had been shown to affect firm performance in another field of research. According to Gaines-Ross (2003), managerial ability could be the most crucial aspect of human resources that can significantly impact firm value. Many financial analysts would

recommend a firm's stock based on the reputation of the firm's CEO as they believe that CEO with high ability will be able to bring sustainable success to the firm or turn around the firm's poor performance. Furthermore, Fahy and Smithee (1999) assert that managerial ability is an indispensable and valued component of every organisation, as managers are accountable for recognising, developing, and using the firm's resources to maximise shareholder value. Inam Bhutta et al. (2021) discovered that managers with greater capability adopt initiative and inventive activities to use firm resources for long-term financial sustainability. Additionally, they discovered that the personal attributes and competencies of a manager drive effective resource use.

High-capability managers are open to risk taking, which is correlated with a higher firm value (Yung & Chen 2018). Phan et al. (2020) discovered that more capable managers have a deeper understanding of their firm's operating environment, allowing them to make better investment decisions and enhance the performance of their organisation. According to Andreou et al. (2013), highly competent CEOs promote increased investment, making their companies less susceptible to financial restraints during times of crisis. Ng et al. (2015) relate management skills with effective monitoring frameworks that improve earnings quality and firm value. In many firms, especially those operating in multiple industries, the managers would have to embark on different projects across different business segments, which would hopefully bring higher profits to the firms. These involved a series of decision-making processes by which managers would have to decide which project to involve, where the funding comes from, and whether to use any leverage in order to maximise the shareholder value. So, logically, it is reasonable to expect that high-ability managers will contribute significantly to the performance of these firms.

The conclusion from the preceding discussion is that one field of research has shown that high-ability managers improve firm performance; albeit with a few caveats (which will be discussed further in subsequent sessions); and another field of research examines specific circumstances or factors that may affect the relationship between diversification and firm value. Therefore, this study aims to bridge the two fields of research by investigating whether managerial ability positively affects the relationship between diversification and firm value.

If the study finds that managerial ability positively affects the relationship between diversification and firm value, then it leads to the following question: who are these high-ability managers? Do they possess any personal traits that would enable firms to discover them? The highlighted research question is related to the real-life challenge of CEO selection. Gottesman and Morey (2010) noted that investors and shareholders are constantly on the lookout for qualified managers who can add value. The CEO's educational background is one of the few publicly available attributes. In other words, if a firm is seeking a new CEO, how does it know that someone is qualified? Does he fit into a particular age profile? Do foreign education and work experience matter?

Recent empirical evidence suggests that CEO attributes such as age, education background, and number of years as a top manager influence firms' performance (Berger et al., 1997; Graham & Harvey, 2001; Bertrand & Schoar, 2003). However, according to Bulent et al. (2013), most studies focus on developed countries, such as the US, leaving a research gap on the effect of CEO characteristics on firm performance in emerging economies.

Although high-ability CEOs should positively affect the relationship between diversification and firm value, empirical studies show that this may not be the actual

outcome. The issue here lies primarily in the agency problem. Agency problem refers to the scenario in which there is a conflict of interest between the agent (employees) and principle (shareholders) or principle-principle. The issue arises when the agent acts against the interest of principle. For example, Campbell et al. (2012) have postulated that high-ability managers are aware that they are difficult to replace, and therefore might abuse the power granted to them. Examples of rent-seeking behaviours cited in prior literature include suboptimal investments (Stulz, 1990), falsified financial reporting, empire building (Armstrong et al., 2010), and increasing the firm size for higher compensation (Baker et al., 1988). In addition, Stulz (1990) and Fama (1980) emphasised the importance of monitoring in preventing managerial rent-seeking. According to the research, high-ability managers are likely to continue making the right decisions to improve the performance of their firms when they are subjected to stringent monitoring.

1.4 Research Question

Based on the research gaps in the preceding section, the following research questions are established.

1. Apart from studies stating that diversification leads to lower firm value, will the effect of diversification on firm value become positive by employing high-ability managers?
2. Does managerial ability's positive effect on the relationship between diversification and firm value vary by CEO personal attributes?
3. Will the positive relationship between diversification and firm value be enhanced when firms have good corporate governance by employing high-ability managers?

1.5 Objectives of the Study

Following the research questions, the three main objectives of this study can therefore be stated as follows:

1. To examine whether managerial ability positively affects the relationship between diversification and firm value.
2. To examine whether the positive effect of managerial ability on the relationship between diversification and firm value varies by CEO personal attributes.
3. To examine whether the positive relationship between diversification and firm value will be further enhanced when firms have good corporate governance.

1.6 Scope of the Study

This study narrows the scope of the study to public listed firms in Malaysia, while examining whether managerial ability positively affects the relationship between diversification and firm value. The following discussion outlines the reasons for setting of this scope.

First, each country has its own unique political and business ecosystems, judicial systems and enforcement, taxation, and accounting regulations. These country-specific institutional characteristics can influence both diversification and firm value at the same time. Undertaking a single country study, Malaysia, this study can avoid endogeneity problems between diversification and firm value and country-specific institutional factors.

Second, the Malaysian corporate sector represents an interesting research avenue to study the relationship between diversification and firm value in situations where the majority of firms are family owned or government linked, managers are frequently family

members or politically connected, family members or political figures also serve on the corporate board, which are unique features of many firms in emerging economies.

Third, previous studies pertaining to the relationship between diversification and firm value focused on firms in advanced economies or large emerging economies, i.e.,, India and China. Thus, the results of this study are useful when extrapolating to other small size emerging-economies.

Finally, listed firms in Malaysia must prepare financial statements in accordance with the Malaysian Accounting Standards Board (MASB) and the Ninth Schedule of the Malaysian Companies Act, 1965. Firms must also meet disclosure standards as part of listing requirements. In addition, the accounting data in publicly released annual reports must be certified by qualified auditors. Therefore, it is reasonable to assume that the quality of the accounting and financial data disclosed by Malaysian listed firms is consistent (Fraser et al., 2006). With the availability of good quality firm-level accounting and stock market data, it is possible to conduct a rigorous empirical study.

1.7 Significance of the study

Although the relationship between diversification and firm value has been extensively studied during the last decades, the focus of most studies had been on diversified firms in developed countries. Due to differences in institutional settings and business environment, the results of most studies are not generalisable to emerging economies. For example, most of the firms in Western developed countries employed professional managers who have little or no control rights over the firm they manage. The condition is in sharp contrast to emerging economies populated with family-controlled and government-link firms with almost no separation between ownership and control. To the best of my knowledge, this

study is the first to examine the role of managerial ability in the relationship between diversification and firm value.

Upper echelon theory implies a need to hire CEOs with personal attributes that match the strategic choice of firms. This study investigates whether CEO age and education play a role in the influence of managerial ability on the value outcome of diversification. In other words, if managerial ability is shown to influence the relationship between diversification and firm value positively, does the magnitude of the positive influence increase when firms hire CEO with higher education or younger/older in age?

Regarding corporate governance, agency theory has been the central theoretical explanation used to explain the misalignment of interests between professional managers and shareholders, leading to diversification discount. However, since there have been increased efforts only in recent years to investigate the impact of corporate governance on the relationship between diversification and firm value in emerging economies (see, e.g., Prabowo and Simpson, 2011 in Indonesia; Charkrabarti et al., 2007 in India; Tan and Tam, 2007 in Malaysia; Guest and Sutherland, 2010 in China; and Almeida et al., 2011 in Korea), the amount of literature on this issue in emerging economies is still limited.

As such, this study aims to fill the research gap in the corporate governance literature, and contribute to a better understanding of the influence of corporate governance practices on the relationship between diversification and firm value, while considering the moderating effect of managerial ability.

On the practical value of the study, the findings are expected to make an important contribution to the recent extensions of the contingent-based perspective on the outcome of diversification. Although previous research had found that relatedness of business segments, market and institutional level factors, industry factors and firm factors are some

of the factors which may determine the sign and size of the outcome of diversification on value (see e.g., Palich et al., 2000; Villalonga, 2004a; Kuppuswamy & Villalonga, 2015; Aggarwal & Zhao, 2009; Campa & Kedia, 2002) to the best of my knowledge, none has focused on managerial ability.

In addition, this study will aid individual managers by making them aware that the ability to maximise the value of their firm's resources is a crucial ability that transcends organisational boundaries. Therefore, managers should take deliberate steps to improve their own abilities, making them more valuable as their careers progress.

This study will also contribute to the upper echelon theory, which posits that organisations must employ CEOs whose personal characteristics align with their strategic choices. This study examines whether the age and education of CEOs have any bearing on the effect of managerial ability on the value outcome of diversification. Therefore, the findings will serve as a reference for determining whether diversified firms should appoint younger or older CEOs, as well as CEOs with or without degrees/advanced degrees, in order to maximise the benefits of diversification.

This study will contribute to the literature on corporate governance and serve as a guide for firms to determine whether the approach to further empower their CEOs (e.g., practise duality) or closer monitoring by their board (majority independent director, practise separate leadership) will yield greater diversification benefits.

Last but not least, policy makers are expected to benefit from this study. If the study demonstrates that older CEOs outperform their younger counterparts and/or that good corporate governance increases the value outcome of diversification, then policymakers should consider increasing the retirement age (at least for jobs requiring

high cognitive ability) and mandating good corporate governance for publicly traded firms.

1.8 Organisation of the Thesis

This thesis is organised in the following manner: Chapter 1 provides an introduction of the study that comprises the background, problem statement, motivation of the study, research gaps and research questions, objectives of the study, scope of the study, contributions of the study, and the organisation of this thesis. Chapter 2 explores and reviews the relevant literature and theoretical concepts, then develops the study framework and hypotheses to examine the stated research problems. Chapter 3 covers the procedures for gathering sample data, the empirical framework, and methodology, including robustness tests and variable definitions. Chapter 4 presents the empirical findings, accompanying analysis, and addresses the relevance of the findings. Finally, Chapter 5 summarises the study's findings, contributions, limitations, and makes recommendations for further research.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

Three primary sections correspond to the three hypotheses in this study. Section 2.2 defines firm value, followed by Section 2.3 on how diversification affects firm value. The benefits of firm diversification are explained. Section 2.4 discussed managerial ability and how it might affect diversification and firm value. A full review of empirical studies and arguments on diversification and firm value follows in Section 2.5. The following Section 2.6 discuss a contingent-based perspective, which underpins most contemporary research. Section 2.7 discusses the relationship between managerial ability and firm value. Section 2.8 discusses how CEO age and education may affect managerial ability, diversification, and business value. Then, the relevant theories and empirical evidence on CEO personal attributes and firm performance are presented. Section 2.9 analyses corporate governance's impact on managerial ability-diversification-firm value. Hypothesis development is covered in Section 2.10. Section 2.11 summarises this chapter.

2.2 Firm Value

The objective of this study is to investigate the influence of managerial ability on the relationship between diversification and firm value. Studies of firm value, or more precisely, the creation of firm value, are at the heart of a diverse range of research fields. Given that the fundamental goal of the business enterprise is to create value, this section of the thesis is structured around the following questions: What is the value of the firm and how is value created within a firm?

When someone invests in a firm rationally, he or she will hope that over time the firm shares will gain value, resulted in some positive return of investment. In essence, any rational investor would hope that the firm's managers would be able to create value for the firm. If one adopts the widely accepted view that the existence of a firm is to serve the interests of shareholders, then the production undertaken must be in pursuit of profits (Barney, 1986; Makadok, 2001).

To address the questions of value creation, we must first understand the activities that create value within the firm. To facilitate meaningful discussion, this study follows Bowman & Ambrosini's (2007) framework by distinguishing between the value-creating roles of various activities within a firm. This distinction enables us to better understand which activities capture value and why they do so. The Bowman & Ambrosini (2007) framework is based on the value chain model proposed by Porter (1985). The researchers regroup the primary and secondary activities in Porter's model into direct value-creating or indirect value creation. Bowman & Ambrosini (2007) framework is also closely related to the resource-based view (RBV), which emphasises creating value through competitive advantage gained from the resources and internal capabilities of a firm, which will be further elaborated.

Consider the firm itself in the role of a customer and supplier. According to Porter's model (1985), any firm can act as both a customer and a supplier by receiving input from suppliers and providing products and/or services to customers. In the role of a customer, the firm would seek more value for money by getting the inputs at a lower price or better inputs at a given price. Acting as a supplier, the firm would then optimise the revenues it had gained from delivering its products and services to customers.

There are five main types of firm activity that directly or indirectly entail value creation, according to Bowman & Ambrosini (2007). Type 1 activities involve the production of products and services. Type 2 activities generate revenues for the firm by selling products and services to customers. Type 3 activities involve purchasing inputs from suppliers. These three types of activities are directly involved in the generation of profits. Type 4 activities are those that contribute to the long-term value. R&D, risk management, production capacity, maintenance, training, and market research are examples of these activities. Type 5 activities are support and maintenance activities such as legal, account preparation, tax administration, and other required tasks to keep the organisation running smoothly. Type 4 and 5 activities do not generate immediate revenues. Instead, they incur costs.

In type 1 activities, the firm strives for higher efficiency in the production of the products and services. These are activities of the value chain, e.g., production and logistic (Porter, 1985). If the products and services are successfully being sold to customers, they bring profits to the firm. Otherwise, it becomes a cost to the firm.

In type 2 and 3 activities, the firms try to generate revenue for their products and services and reduce input costs. Therefore, the firm will try to optimise the prices, balancing between profits and sales volume. A higher price will typically lead to lower sales volume and vice versa. In these activities, the firm acts as both a supplier and a customer to increase profits for its shareholders (Bowman & Ambrosini, 2007).

Type 4 activities are discretionary expenditures such as R&D, risk management, and training that incur costs and are funded by current profits or additional capital raised from investors. These activities might increase the future value of the firm if performed correctly, but the results are unforeseeable. As a result, the firm must decide whether to

invest a portion of profits in these activities or to keep the gains and pay dividends to investors (Eisenhardt and Martin, 2000). Type 5 activities are necessary for the continuity of the firm but do not generate profit, only incur costs (Porter, 1985). The firm will perform these activities at a minimal cost. Lowering costs increases profits, which boosts the firm's value.

As indicated in the discussion, the value creation process consisted of a series of decision-making processes in areas such as production, supply chain, marketing, after-sales service, human resource management, infrastructure, and technological development. Any firm that focusses on understanding and developing the know-how in optimising value creation activities will almost certainly increase net profits and improve firm performance, especially when firm performance is measured by metric such as return on assets (ROA) and return on equity (ROE).

But ROA and ROE are accounting-based performance measures that did not take into account investors' expectations about the firm' prospects. Market-based performance measures such as Tobin's q, on the other hand, incorporate stock prices into its calculation (Ng, 2012). Stock prices are forward-looking in the sense that investors purchase and sell stocks based on their predictions for the future rather than on what happened yesterday or today. A firm may, for example, report outstanding earnings per share and net profit figures in a particular quarter. However, if they also lower revenue and earnings per share growth forecasts for the following several quarters, the stock price will almost surely fall.

Therefore, based on the discussion in the previous paragraphs, it can be concluded that firms will strive to optimise every activity in the value creation process in order to improve firm performance. However, investors care more about firm value than firm past

performance. Unlike market-based performance measures and stock prices, accounting-based measures such as ROA and ROE do not reflect firm prospect. As such, if a firm has the know-how to optimise value creation activities, focussing on one industry makes little sense. The potential for growth in that industry may eventually be exhausted. Transferring know-how into different industries is one of the strategies to pursue continual growth and increase firm value (Nonaka & Teece, 2001).

2.3 Theoretical Justification on How Diversification Creates Value

Porter (1985) suggests that a firm can gain a competitive advantage by transferring its core skills and resources into a new business segment. This is the basic idea of resource-based view that due to market imperfection, a firm with unique resources may not be able to sell its excess resources. Diversification would therefore be an optimal way for the firm to use the resources.

Whittington and Mayer (2000) stipulate that excess resources motivate firms to diversify. The nature of the resources will determine the type of market in which the firms choose to enter. Skills and resources which can be shared across different businesses can roughly be classified as physical resources (e.g., technology and production plant), intangible resources (managerial expertise, goodwill, brand name), and financial resources. Sharing resources across many businesses can result in cost savings, create a long-term competitive advantage, and add more value to the firm (Miller, 2006). In addition, diversification may also lead to lower operating costs, since resources are shared by various businesses (Markides and Williamson, 1996). Furthermore, according to Lewellen (1971), a diversified firm with uncorrelated business segments has a healthier

cash flow profile, higher debt capacity, and lower risk because all segments are unlikely to be in crisis at the same time.

Diversification may also be driven by the needs of firms seeking growth opportunities. This is particularly true for firms in an industry with limited growth. By redeploying their resources and capabilities, firms could be more productive and profitable. According to Villalonga (2000b), a firm can diversify in order to gain market power by using earnings from certain divisions to support other divisions in adopting predatory pricing, which could push certain competitors out of the market. More specifically, through diversification, firms stand to benefit from financial advantages, operational efficiency, and market power, which will be further elaborated in the following subsections.

Efficient Internal Capital Market

Stein (2002) and Shleifer and Vishny (1991) argued that management of diversified firms is more aware of the various investment opportunities within their business portfolios than external financiers and has incentives to allocate funds efficiently based on the information available. Stein (1997) refers to this process of internal capital allocation as "winner-picking." Top management of diversified businesses is obligated to allocate funds to the most profitable sectors, as their private compensation is proportional to the profits earned by the divisions they oversee. Similarly, Gertner et al. (1994) suggested that management of diversified businesses has the authority to select which segments receive additional funding. In contrast, external financiers, such as bankers and debtors, usually do not have these rights. Therefore, these internal capital providers will pay closer attention to the segments, as they stand to benefit from the revenues generated by these

segments. External capital providers do not have such information and power and, therefore, have less incentive to monitor the performance of the segments. Moreover, internal capital allocation is considered more efficient and is likely to add more value to firms because of the monitoring effect.

The benefit is amplified in new ventures because external financial providers are likely to have insufficient information and, hence, less capable of monitoring the business than the firm's managers (internal capital providers). In conclusion, the theoretical arguments show a smart-money effect (Stein, 2003), where internal capital providers perform better than eternal capital providers at allocating funds to winner segments.

In addition, external financing can be difficult or expensive to secure at times. A division of a diverse firm may profit from internal funding from other divisions in the same firm in such a scenario (Erdorf et al., 2013; Barney & Hesterly, 2015; Purkayastha et al., 2012; Martin & Sayrak, 2003). In this instance, early studies such as Alchian (1969) and Weston (1969) argue that diversification creates value for firms, as diversified firms effectively benefited from lower transaction cost compared to those in need of external capital. A focused firm, on the other hand, is nearly wholly dependent on external finance, which is almost always more costly than the company's own internal capital (Purkayastha et al., 2012). Raising capital from within a firm often requires less time and has lower transaction costs than funding from outside sources. By lowering transaction costs connected with capital raising, a diversified firm may have a competitive advantage in terms of efficiency (Erdorf et al., 2013; Purkayastha et al., 2012). Furthermore, according to Hoang et al. (2021), CFOs frequently claim that corporate diversification has a substantial positive impact on their firms' ability to raise external finance.